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Weighing South Africa's Pluses, Minuses...and Maybes

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South Africa continues to be a country of great potential. It also continues to be a country of economic disappointment. South Africa's structural issues are well documented and will have a long-term impact on the economic growth potential of the country. Cyclical forces also impede improvement in the economic outlook that could help the government address those longer-term structural growth constraints. Here, we review an outlook of great promise but one that is lacking in its delivery.

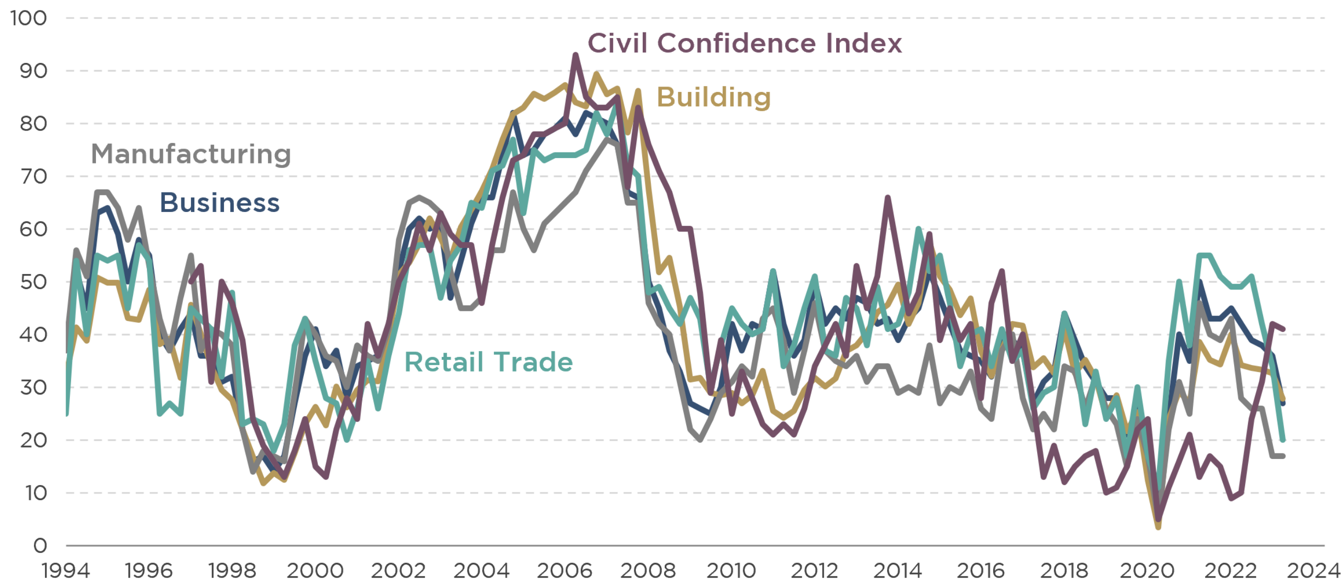
Growth Prospects

What is striking about the South African economy is how down-in-the-dumps both business and consumer sentiment are (see Exhibit 1). Looking just at business sectors, there is weakness across the board. Retail sector confidence has been plunging, too, reflecting weak consumer confidence, a 33% unemployment rate—which includes youth 18-24 years shockingly near 50%, and modestly growing earnings—which are declining in purchasing power. Against this grim backdrop, businesses are unlikely to invest in equipment, plant, and people over the short term.

1

South Africa: Confidence Indicators

Index, As of 4/1/2023



Source: Brandywine Global, Macrobond, Bureau for Economic Research (© 2023)

Yet, we believe South Africa can still surprise positively. Take the recent release of economic growth for the first quarter. Many analysts expected the economy to slip into recession, exhibiting the rule-of-thumb, back-to-back quarterly declines in real gross domestic product (GDP). Instead, South Africa managed to eke out a minimal gain in output (see Exhibit 2). But a gain is gain, and the 0.4% quarterly growth rate was broad-based, following the fourth quarter's 1% drop. Manufacturing, finance, real estate, and business services boosted the economy. This was an amazing performance for the economy, given the strains on the country's electricity grid.

2

South Africa: Gross Domestic Product at Market Prices

% Period-over-Period, Seasonally Adjusted, Annual Rate, As of 1/1/2023

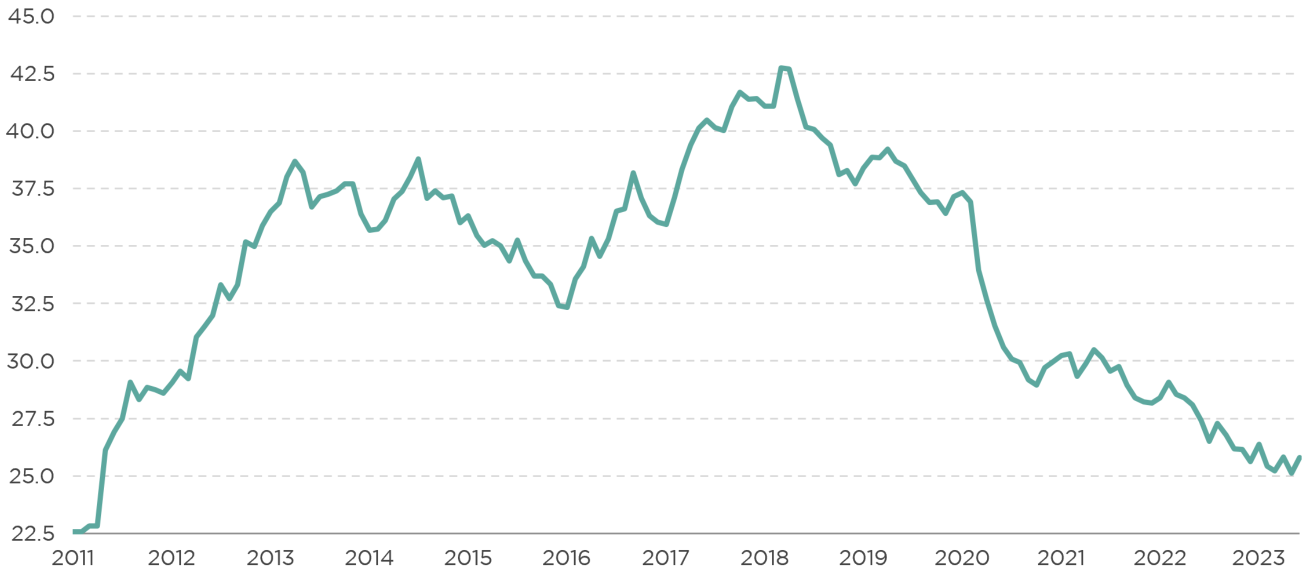
Source: Brandywine Global, Macrobond, Stats SA (© 2023)

We believe this is an economy that will continue to move in fits and starts, unable to sustain much forward momentum in the short term. The inability of the country's largest power utility, Eskom, to produce a reliable supply of electricity raises economic uncertainty and hampers economic decision-making, like investing in new facilities or attracting foreign direct investment (FDI). Poor economic prospects led investors, especially foreign investors, to eschew South African assets (see Exhibit 3). Foreign capital inflows are important for financing a current account deficit likely to widen over the next two years.

3

South Africa: Non-Residents Holding of Domestic Bonds

%, As of 6/1/2023



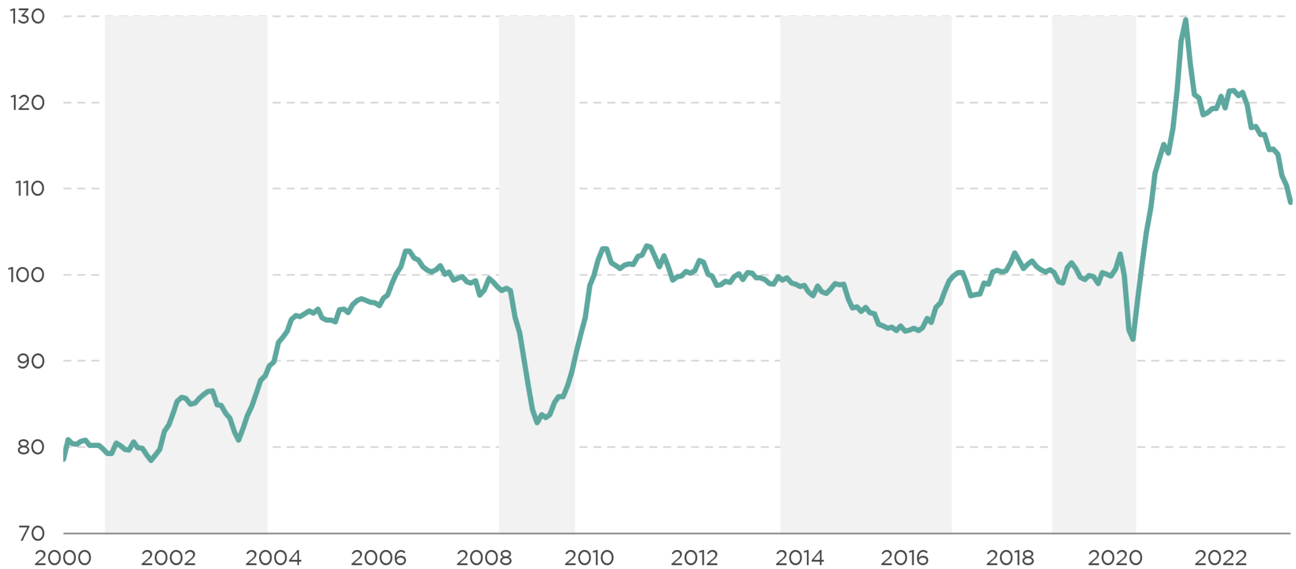
Source: Brandywine Global, Macrobond, South African National Treasury (© 2023)

Perhaps the country's leading indicators tell the tale (see Exhibit 4). Leading indicators suggest the economy could already be in a recession. However, our view is that pedestrian economic growth is the more likely outcome, with an opportunity for the economy to surprise.

4

South Africa: Leading Indicators

Index, Seasonally Adjusted, Shading denotes recession, As of 5/1/2023



Source: Brandywine Global, Macrobond, South African Reserve Bank (© 2023)

Weighing Minuses, Pluses, and Maybes for South Africa

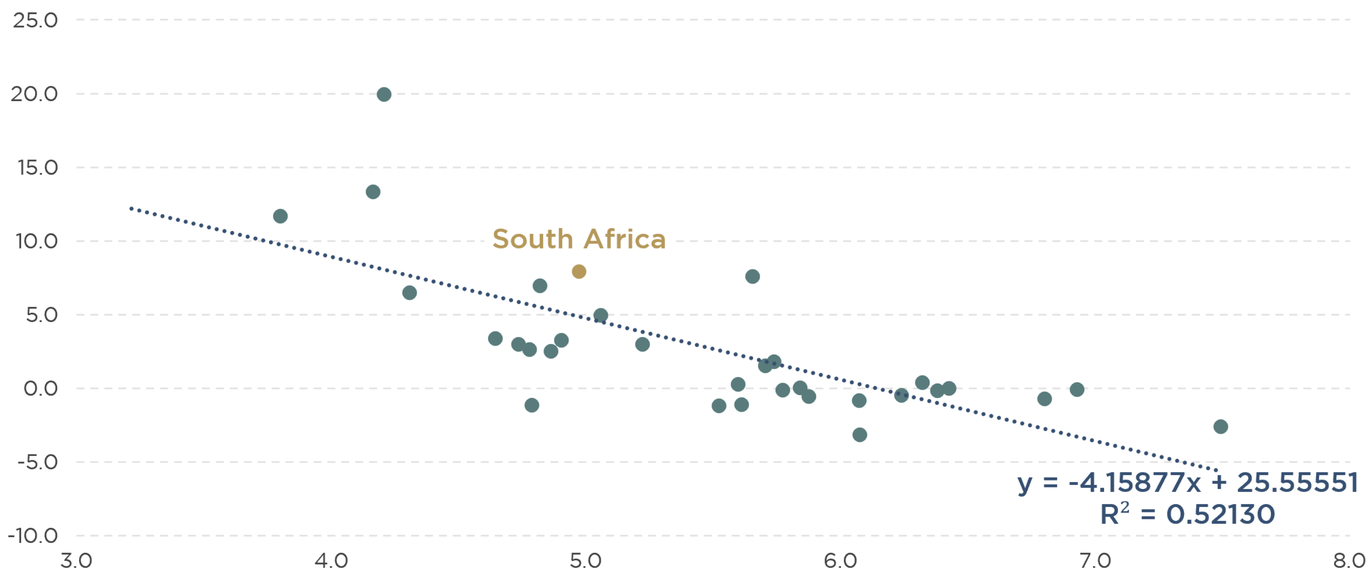
South Africa's negative forces come readily to mind, pushing the potential positive catalysts completely out of the picture. Yet, recent market movement of South African assets suggests a bit of optimism may be creeping into investor thinking. Equities, based on the Johannesburg Stock Exchange, have rallied off their lows in late September last year, but since have become rangebound. The stock market's stall could perhaps be over the outlook for future growth, or perhaps over the drag load shedding, which is the power utility's method for balancing energy supply and demand by temporarily turning off electricity to certain regions or users, has exacted on the economy.

The prospects may be turning for the sovereign bonds and the rand (ZAR), as the worst news appears priced into the government bonds and the currency. Bond yields have moved lower, following the recent diplomatic dustup with the US over a Russian sanctions' violation. On the currency front, ZAR appears to have stabilized and is one of the better performing emerging market currencies over the last month. Exhibit 5 indicates that the interest rate spread between South African and US bonds may be poised to compress in favor of South African bonds.

5

Emerging Markets: Combining Economic and ESG Factors

Combined Economic+ESG Scores (x-axis), Nominal Yield Spread Against US (y-axis), As of 7/14/2023



Source: Verisk Maplecroft, Brandywine Global

Let us look at some South African minuses, pluses, and maybes:

1. The Geopolitical Kerfuffle

South Africa's recent actions have triggered criticism from the US, especially over South Africa's relationship with Russia. First, there was the possibility that Vladimir Putin would attend the BRICS bloc summit for Brazil, Russia, India, China, and South Africa. This event would require South Africa as a signatory of the International Criminal Court (ICC) to arrest Putin as a war criminal. Second, the potential BRICS controversy added to the US's earlier ire over joint military operations between South Africa and Russia and South Africa's neutral posture on the Ukraine war. Lastly, the US ambassador to South Africa blasted the country following an allegation that munitions at a South African naval base were loaded onto a sanctioned Russian commercial vessel. These conflicts with the US could hamper South African exports under the African Growth and Opportunity Act (AGOA). Thus far, these recent actions have not resulted in any US economic retaliation, and the US's ruffled feathers have been smoothed.

2. The Fits-and-Starts Economy

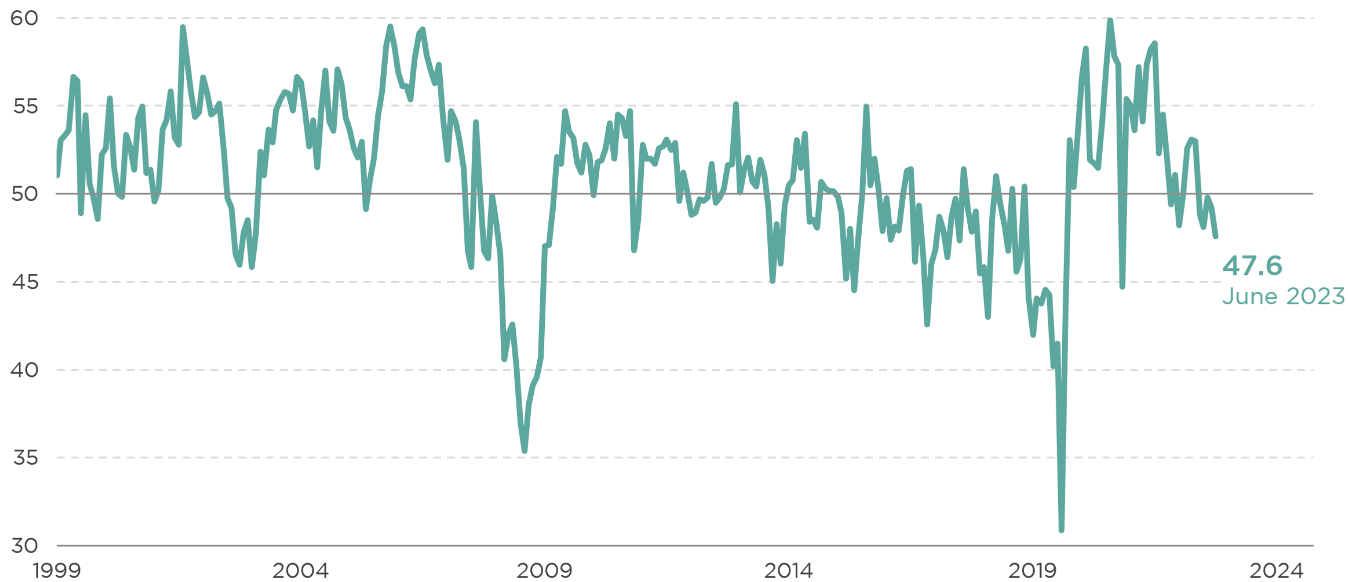
South Africa's economy continues to move in fits and starts, as noted above. Fundamentally, domestic demand remains weak. South Africa's Purchasing Manager's Index (PMI), following the post-COVID rebound, has continued to slide lower (see Exhibit 6). It is now in contractionary territory, confirmed by the weakening leading indicators. Industrial production is increasing at an annual rate of just 1.7%, based on data from Haver Analytics and Statistics South Africa. There is also Eskom's unreliable electricity provision and frequent load shedding. Consumer demand remains weak, too, with retail trade sales falling over the last year, according to Statistics South Africa. Along with a high unemployment rate, South African consumers are hamstrung by a

falling living standard, income inequality, a lack of employment opportunities, and, recently, rising food prices.

6

South Africa: Purchasing Managers Index

Index, Total, Seasonally Adjusted, As of 6/1/2023



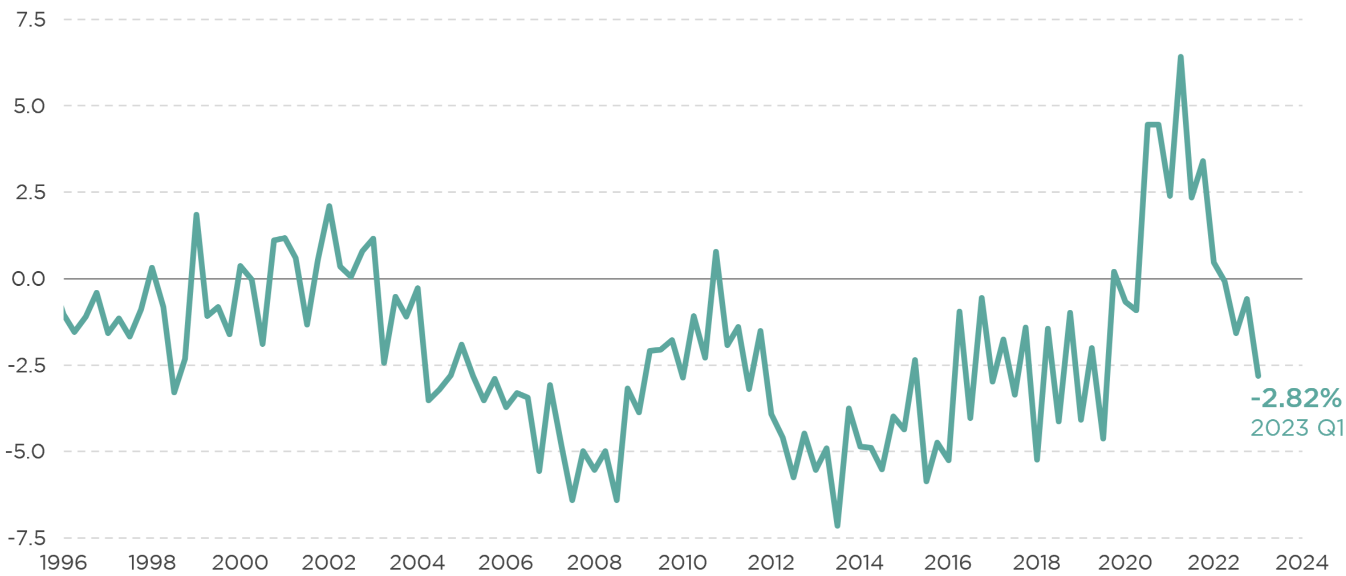
Source: Brandywine Global, Macrobond, Bureau for Economic Research

The country's external position is also deteriorating (see Exhibit 7). Initially, the post-COVID global rebound stimulated the economy in South Africa. Trade improved, and the current account dramatically shifted to a surplus exceeding 6% in April of 2021. Commodity prices surged. Profits and government revenue beat expectations. Elsewhere, however, China's economy failed to gain economic momentum as its economy stalled under the weight of its zero-COVID policy, and the global economy subsequently faltered. That put pressure on commodity prices, negatively impacting South Africa's external position. Most recently, the trade surplus improved, helped by service exports and improving tourism. Still, the structural primary income deficit and weak terms of trade will drag on the external account. The external account will have to be financed, and that requires foreign capital flows into South Africa, something that has yet to occur. An offset is the country's net creditor status.

7

South Africa: Current Account Balance as % of GDP

%, Total, Current Prices, Seasonally Adjusted, Annual Rate, As of 1/1/2023



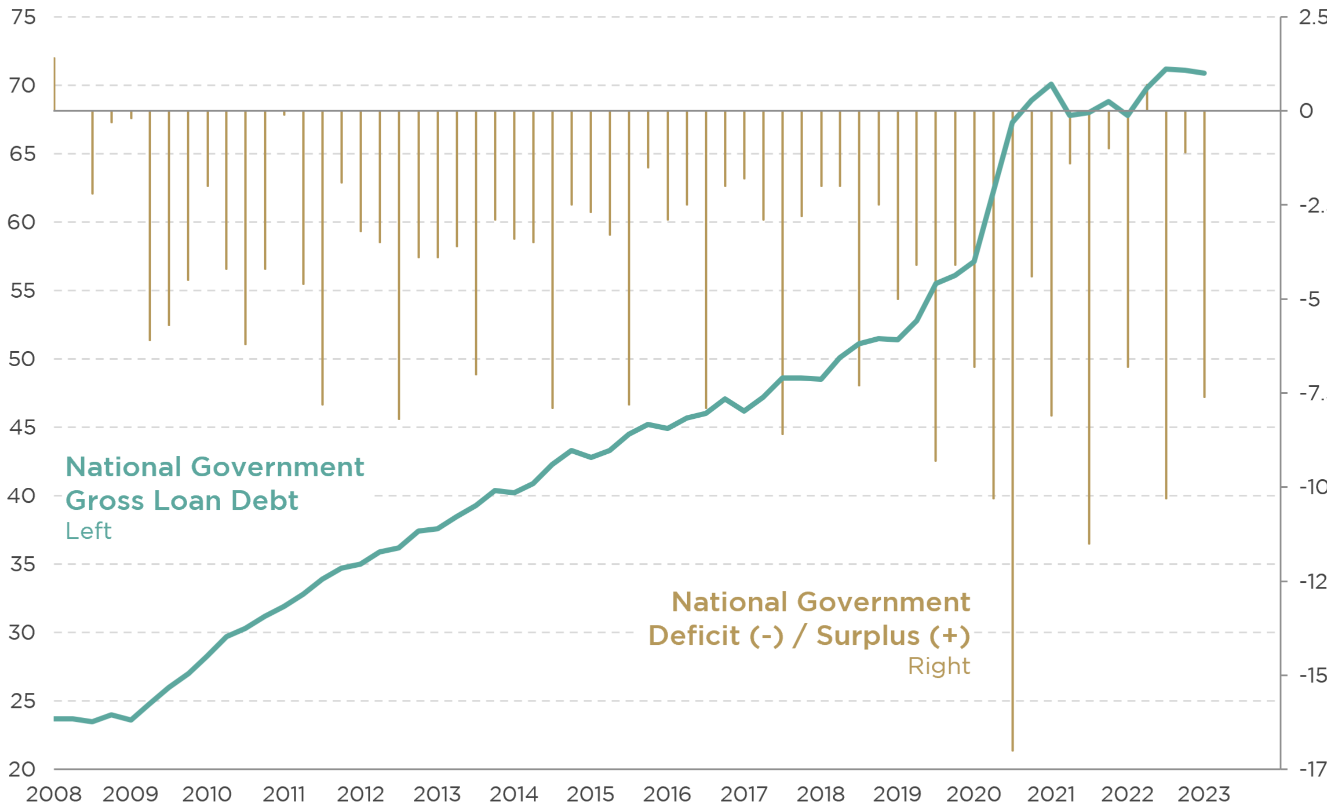
Source: Brandywine Global, Macrobond, SARB, Stats SA

Despite an improvement in its deficit post-COVID, South Africa is seeing its fiscal position begin to deteriorate, partially the result of the weakness in commodity prices, which also has hit corporate income taxes (see Exhibit 8). Overall, a weak economy will reduce total tax collections, which raises the risk of a widening fiscal deficit. Concerns had already been expressed that government revenue assumptions are too optimistic. Moreover, the government's budget forecast does not include the 7.5% public worker wage increase and future social safety net spending, e.g., healthcare. Such factors could produce greater government sovereign issuance, potentially raising the government's interest expense. The deterioration in the deficit and the increasing debt-to-GDP ratio raises the risk of actions by the credit rating agencies.

8

South Africa: Public Debt vs. Budget Balance

% of GDP, As of 1/1/2023



Source: Brandywine Global, Macrobond, SARB

Not every economic force is weakening the South African economy, however. Two forces could be positives for the economy. Inflation is receding, and energy-related reforms, including Eskom debt relief, have led to an investment surge in private electricity generation by consumers and businesses.

The South African Reserve Bank (SARB) is the country's monetary authority and is an aggressive, inflation-targeting central bank. Currently, the bank has a 3-6% inflation target range, and June's consumer price index (CPI) dipped below the upper end of the inflation target range. Headline inflation dropped to 5.4% and the core rate fell to 5%, according to Statistics South Africa. Better inflation and the weak economy led the SARB to hold its policy rate unchanged at its July meeting, following a hiking cycle that consisted of a 475-basis point rise in the policy rate.

Yet, the SARB may not have reached the terminal rate, and a victory declaration on inflation may be premature. Higher electricity tariffs, for example, are in the offing. Household inflation expectations have become unanchored (see Exhibit 9). Despite the SARB's reputation as an inflation fighter, inflation expectations are over 8%, well above the upper range of the bank's inflation target. Such an acceleration in inflation expectations could affect wage demands as workers fight to regain some purchasing power.

9

South Africa: Household Inflation Expectations – Next 12 Months

%, Not Seasonally Adjusted, As of June 30, 2023

Source: Bureau for Economic Research, Haver Analytics

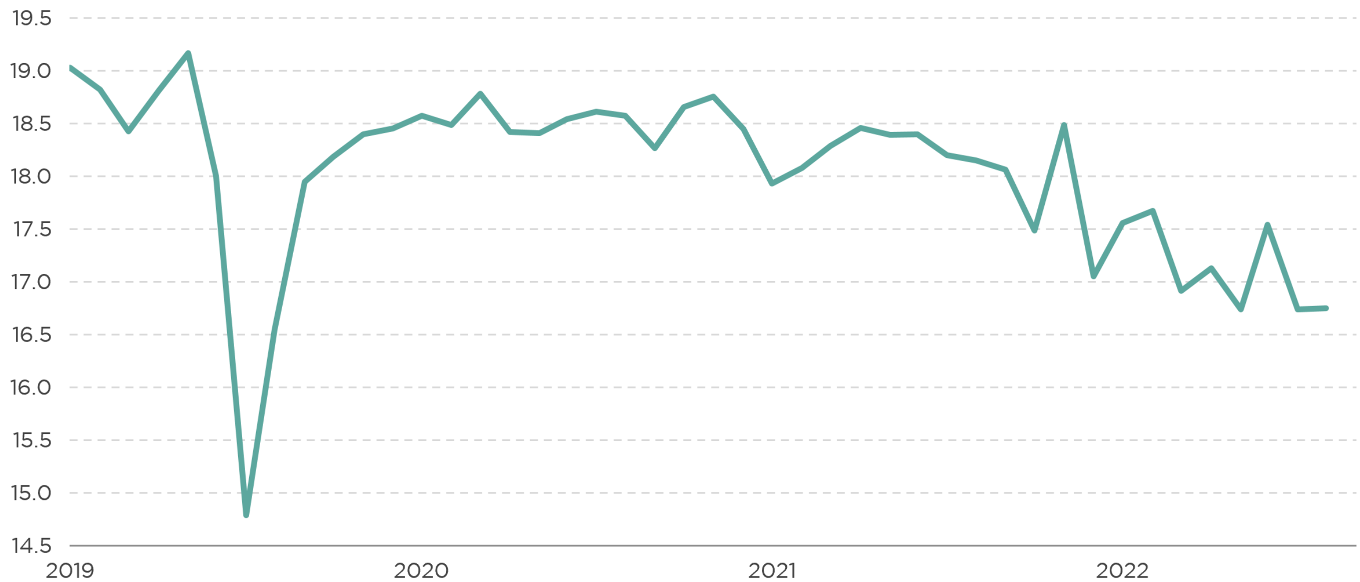
Food prices also could accelerate once again. South Africa, a food insecure country, is a net importer of wheat, as well as cereals. With Russia saying it will not permit Ukraine to ship its grain, geopolitics could impact supply and food prices in South Africa. Also, the El Niño weather pattern has arrived, promising warmer waters and dryer conditions. Such a weather pattern can reduce agricultural production and generate inflation. It can also create extreme weather conditions. Nonetheless, SARB efforts have thus far squeezed inflation back into the target range, and the central bank will remain on watch.

As stated previously, Eskom has been an unreliable supplier of electricity to the economy. As much as any other factor, electricity availability has stymied economic activity. Furthermore, electricity availability in South Africa has been steadily declining (see Exhibit 10). Eskom has faced production failures and closed facilities for maintenance, causing electricity production to fall over 12% over the last 2 years. That drop in electricity availability led to severe bouts of load shedding, temporarily shutting off parts of the electricity grid to prevent a systemwide blackout. Needless to say, miners and manufacturers cannot operate under such severe constraints. Some changes, though, have been set in motion that should relieve some of the pressure on the electric grid and on economic growth.

10

Electricity Available for Distribution in South Africa

Megawatt-hour, Million, Seasonally Adjusted, As of 5/1/2023



Source: Brandywine Global, Macrobond, Stats SA

Some of the electric plants will be coming back online sometime in 2023. And with only about a month and a half left, this winter in South Africa has not been as severe as was first expected, another positive. However, the big change, the change that could have the greatest medium- and long-term effects on growth, has to do with energy reforms that now allow private energy production, which potentially permits households and businesses to circumvent Eskom and generate their own electricity. The government also is providing solar panel tax incentives, and households and businesses can claim a tax deduction for investment in renewable energy. This electricity substitution will take time to fully manifest in the economy, but the renewables surge could be the solution to bypassing Eskom undependability and unleashing potential growth in South Africa.

Conclusions

- South African growth is lackluster, and the country has flirted with recession. Thus far, recession has been avoided, but a lack of business and consumer confidence could make it a reality. A big future boost to the economy could be the return of global growth, led by a recovering China. That recovery would be a bonus for South African mining and could lessen budget deficit deterioration via rising revenue.
- The country could be propelled by at least two positive catalysts: improving inflation and the private sector's electricity investments. Inflation has improved and could allow the SARB to begin lowering interest rates later this year. The most significant catalyst to growth is likely the electricity investment. A reliable supply of electricity should be a confidence booster.
- The government must address the structural economic forces that constrict growth. The structural forces include addressing social issues, like poverty and employment, and a challenged infrastructure that needs investment.

Muddling forward seems to be the most likely course for the South African economy. The country has proven time and again not to count it out entirely just yet. We think South Africa can manage meager economic growth in the near term, with an opportunity to surprise positively.

Index Definitions

The FNB/BER Building Confidence Index reveals the percentage of respondents that are satisfied with prevailing business conditions in six sectors, namely architects, quantity surveyors, main contractors, sub-contractors (plumbers, electricians, carpenters and shop fitters), manufacturers of building materials (cement, bricks and glass), and retailers of building material and hardware. The composite RMB/BER Business Confidence Index (BCI) takes the percentage of respondents that rates prevailing conditions as satisfactory as indicator or proxy of business confidence. The BCI is the unweighted mean of five sectoral indices, namely that of manufacturers, building contractors, retailers, wholesalers, and new vehicle dealers. The FNB/BER Civil Confidence Index reflects the state of business conditions in the civil engineering industry. The confidence indices can vary between 0 and 100, where 0 indicates an extreme lack of confidence, 50 neutrality and 100 extreme confidence.

The BER's Retail Trade Survey covers the retail, wholesale, and motor trade sectors. Apart from business confidence, the survey data highlights current trends in business conditions, sales volumes and selling prices.

The Absa Manufacturing Survey is a quarterly report on the results and implications of the latest BER survey of manufacturing firms. Released in advance of official indicators of activity, it provides reliable and up-to-date information on current trends and valuable perspective on the outlook for the sector. Apart from business confidence, the survey data highlights current and expected trends in business conditions, domestic as well as export sales volumes, production volumes, the number of factory workers, input costs and selling prices, fixed investment, and stock levels.

South Africa Composite Leading Indicator (CLI) is designed to provide early signals of turning points in business cycles showing fluctuation of the economic activity around its long-term potential level.

The Absa Purchasing Managers' Index™ (PMI™), compiled by the Bureau for Economic Research (BER) and sponsored by Absa, is based on the widely used and highly regarded Purchasing Managers Index (PMI) produced by the Institute for Supply Management (ISM) in the US. The headline PMI is calculated as the weighted average of the following indices: Business Activity (20%), New Orders (20%), Employment (20%), Supplier Deliveries (20%), and Inventories (20%). A value of 50 indicates no change in the activity, a value above 50 indicates increased activity, and a value below 50 indicates decreased activity.

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