THE MEDIUM-TERM BUDGET POLICY STATEMENT

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VIEWS AND INVESTMENT IMPLICATIONS

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MARKET REACTION

The MTBPS proved a massive shock to the market, causing huge disappointment mainly as a result of the serious fiscal slippage it highlighted: gross debt/GDP is expected to exceed 60% by 2022 (see Graph 1). Apart from the shock R51 billion shortfall in revenue in the current fiscal year, the extent of the deterioration in the outlook also propelled sentiment, with substantial downward revisions to the National Treasury (NT)'s growth outlook and commensurate reductions in expected tax revenue.

- NT nearly halved its real GDP growth forecast for the 2017/18 fiscal year to 0.7% from 1.3% in the February Budget, rising to a tepid 1.9% by 2020. Tax revenue assumptions have been lowered commensurately, amounting to a massive R209 billion shortfall over the three fiscal years to 2019/20. The budget states that "absent higher growth or additional steps to narrow the budget deficit, the debt/GDP ratio is unlikely to stabilise over the medium term".

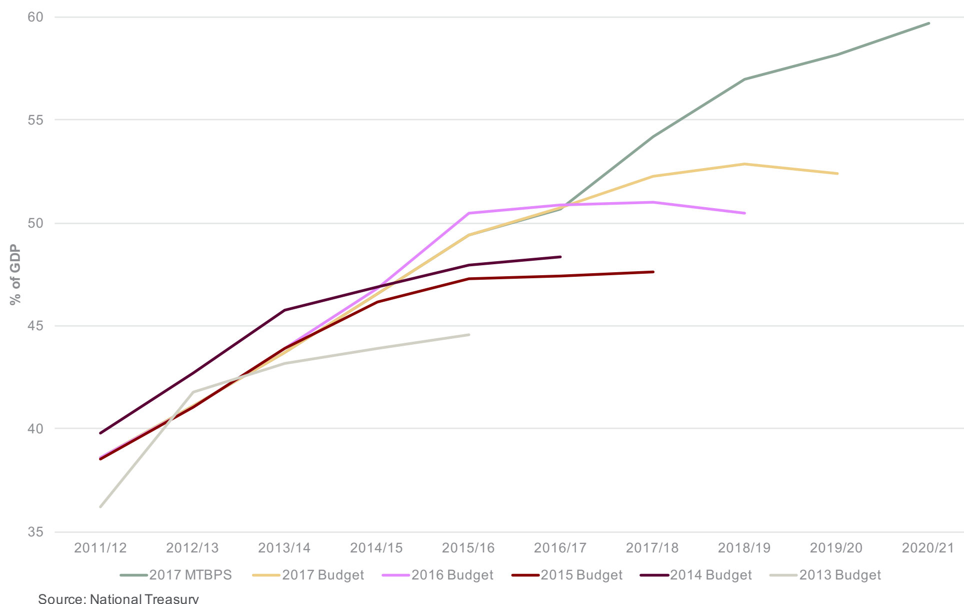
Compounding the poor state of affairs is the tale of woe that is the SOE's, with NT having to take further action to shore up the finances of the weakest. Total interest payments by SOE's are set to rise from R50 billion currently to around R69 billion by 2019/20, with NT highlighting concerns that some will have insufficient cash flow to meet their obligations.

Much of the commentary also focused on the observed "lack of a plan" to move South Africa forward. Following on from all of the above, the vast majority of commentators now fully expect a downgrade of local market debt by Moody's and S&P Global after their reviews at the end of November. NT even implied this in the MTBPS, noting that "refinancing will be done at higher forecasted long-term interest rates".

WHAT WERE NATIONAL TREASURY THINKING?

The common narrative is that this year's MTBPS is an attempt to speak in an entirely forthright manner about the situation in which the country finds itself. Under this narrative, National Treasury is attempting to regain some of its lost credibility, which had been undermined due to its endless missed forecasts and over-optimism in past budgets. NT has been forced to systematically downgrade its growth outlook in recent years, undermining the market's confidence in its forecasts. The MTBPS view is now far more closely aligned to current market consensus.

GRAPH 1: DEBT TO GDP CONTINUES TO RISE



Source: National Treasury

As such, NT's previously optimistic forecasts may have created complacency in other government departments, which assumed that since things were getting better under the budget forecasts, they did not need to take the hard decisions, like cutting spending.

NT is not in control of the primary levers that could lift South Africa onto a higher growth trajectory. By presenting a "raw facts" view, and bringing the Minister's political capital to bear in Cabinet, the SOE's and the economy at large, NT is hopeful they can accelerate a broader agenda of reform. For example, in the MTBPS they have assumed a 7.3% wage increase for the public sector, which implies a base raise of no more than CPI (after adjusting for higher allowances). This indicates they are positioning themselves as a leading fighter for cost containment in the upcoming public sector wage negotiations, where a favourable outcome is critical.

THREE POSITIVE POINTS

First, the Minister confirmed in the MTBPS that the nuclear energy programme is not currently affordable. The statement that nuclear should remain part of the energy mix refers to the idea that once the South African economy is growing more strongly and electricity demand begins to accelerate, nuclear could then come back onto the table.

Secondly, NT is working hard to introduce reform in the SOE's. New boards for certain SOE's have either been announced or will be announced shortly. Board composition is critical to creating confidence for the future and averting the risks that have been rising as a result of poor management and governance, and corruption.

Thirdly, NT will be introducing a more stringent process for the dispensation of guarantees to SOE's which will include more covenants that will seek to ensure that the SOE's remains well run and on track.

PRUDENTIAL'S VIEW

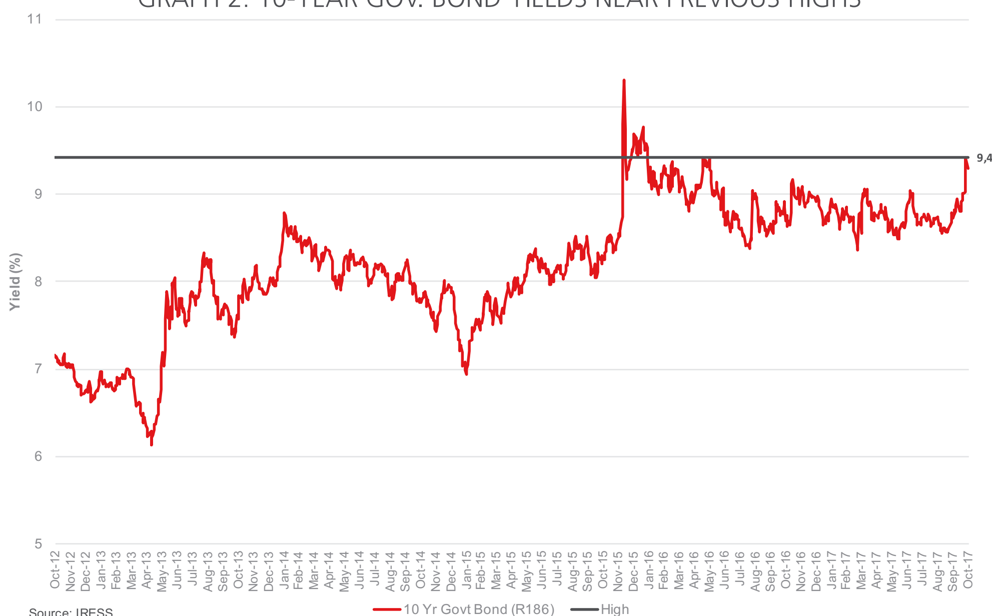
The Treasury's view of the future in terms of growth

forecasts is now closely aligned to the market consensus, whereas previous budgets appeared to present overly optimistic views of the future.

- Treasury's revenue forecasts surprised the market in their pessimism, and the deficit projections were significantly worse than expectations, implying an increased realism and a greater probability of achieving what has been set out.
- It remains to be seen if these shock tactics stir a response in other government departments and real change can be engendered from the final realisation that we have run out of road.
- The probability of a ratings downgrade has to now be significantly higher. Growth, a primary concern of the rating agencies, is lower, the deficit higher and no substantive new initiatives to improve these have been announced.
- A double downgrade by Moody's and S&P Global would force South Africa out of the World Government Bond Index (WGBI). There would undoubtedly be international funds, particularly tracker funds, that would need to sell, and all other things being equal, this would require higher bond yields to attract new buyers. That said, if the experience of entering the WGBI serves as an appropriate example of what could happen, flows would take place over a period of time. There was little to no discernible effect on SA bond yields in October 2012 when entry took place, and in the months leading up to entry, worldwide emerging bond markets were rallying, so although SA 10-year bond yields fell 100bps over June and July 2012, so did the yields of markets like Turkey and Brazil. This makes it difficult to determine a specific WGBI effect.
- In Prudential's view, bond yields materially re-priced in response to the MTBPS, rising from around 8.8% (for the 10-year government bond) to 9.4%. Yields were only substantially above this level in the roughly two months following Nenegate (see Graph 2). In our view this re-pricing represented an over-reaction, and we added to bond positions at around these yield levels with the view that these levels amply compensated investors for the risk involved.
- On Friday, two days after the MTBPS, the bond market retraced about half of its losses, with 10-year yields ending the day at around 9.13%. Relative to expected inflation of 5% in 2018 and longer-term inflation of 5.7%, this yield still appears to be pricing in some downside risks. By comparison, it is not far below similar maturity yields in Brazil, where the annual budget deficit is expected to be 8.1% of GDP this year, 7.3% next year and 6.1% in 2019. SA compares favourably at 4.3% of GDP this year, and 3.9% for 2018 and 2019.
- Prudential supports the need for the government to introduce improved certainty over asset rights, such as providing clarity on the Mining Charter and its land reform programme. We recognise that the long-term future of South Africa cannot be served by growth below 2%, and that growth- and employment-enhancing initiatives are essential to our long-term future. Failure to implement such initiatives will indicate that National Treasury has failed in its bid to change the nation's current course, which has been one of deterioration against a global backdrop of improvement. While it is tempting to suggest that such a negative scenario is inevitable, history tells us that such grand-standing (and extreme) forecasts are rarely accurate, and in any case ignore what else might be occurring on the global stage.
- In terms of asset positioning, our funds reflect our view that valuations of bonds are modestly attractive, with a similarly modest long duration and overweight asset allocation position. We also remain long South African equities, which offer a partial hedge against dire outcomes under which the rand could be expected to perform very poorly. In global portfolios we retain our maximum permitted exposure to hard currency assets for the same reasons.

The next few months will be critical. We remain optimistic that NT will be successful in its endeavours to create an impetus within government more broadly that lifts SA on to a higher growth trajectory. Our process is valuation focused and has generated superior returns over the long term. ■

GRAPH 2: 10-YEAR GOV. BOND YIELDS NEAR PREVIOUS HIGHS



Source: IRESS