M&G Insights

MTBPS Preview: Hoping for the best, but prepared for the worst

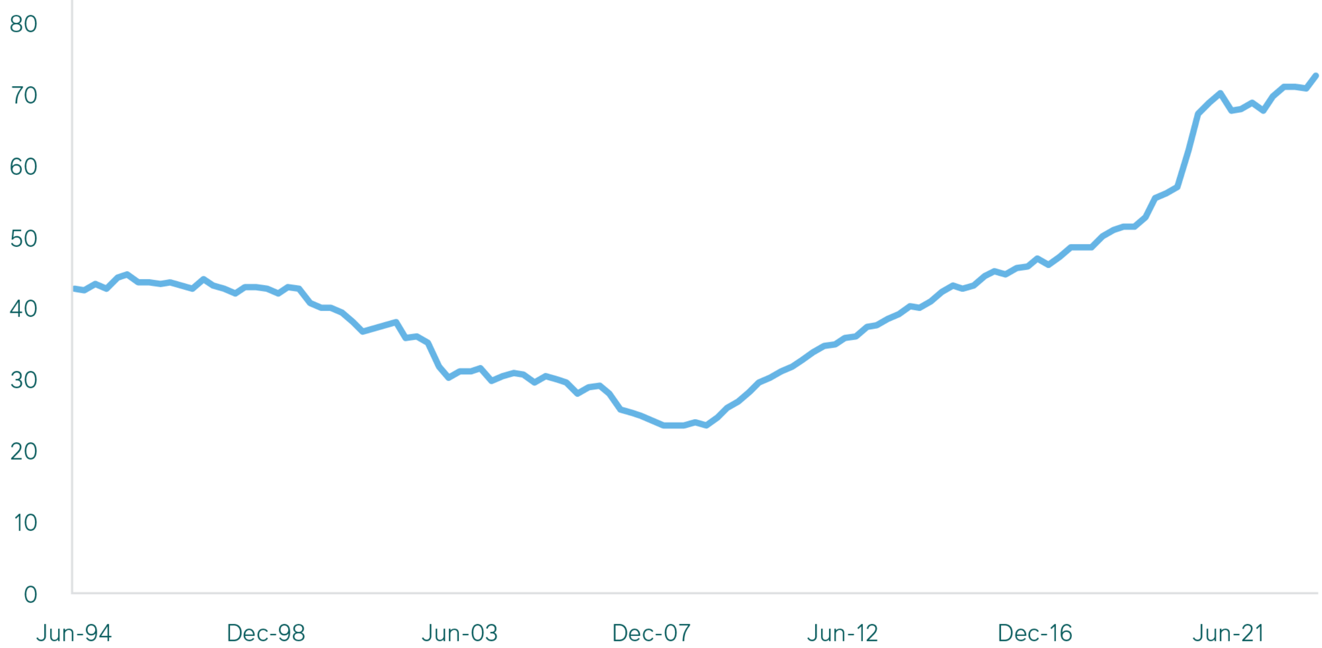
October 2023

Bulent Badsha
Portfolio Manager at M&G Investments

The South African fixed income market keenly awaits the upcoming Medium Term Budget Policy Statement (MTBPS) on 1 November 2023. In managing the **M&G Enhanced Income Fund** we make a concerted effort to understand the fiscal policy stance adopted by government as it affects our interest rate risk (duration) position and government bond exposure. The MTBPS was first introduced by former Minister of Finance Trevor Manuel in December 1997, providing an update on the National Treasury's economic forecasts as well as government revenue, expenditure, and the resultant budget balance projections for the current and ensuing three fiscal years. It is sometimes referred to as the "mini budget" as it provides a half-time update on the state of the fiscus between annual February National Budget Reviews and lays out the operational plan that gives effect to existing government policies.

In our opinion, the one economic statistic in the MTBPS that best encapsulates the strength of government finances through time is the government's debt-to-GDP ratio. As shown in Graph 1, democratic South Africa inherited a ratio of 42.7% in 2Q94 and it remained relatively stable during the formative years under former President Nelson Mandela. It reduced significantly to 23.5% in 3Q08 due to the prudent fiscal policies adopted under former President Thabo Mbeki's tenure and the implementation of sound financial management by former Finance Minister Trevor Manuel and his team.

Graph 1: South Africa's debt-to-GDP ratio has been climbing since 2008
(Debt to GDP %)



Source: M&G Investments, SARB

The National Treasury built tremendous amounts of credibility under Manuel. They did this by largely under-promising and over-delivering on government revenue and expenditure, with the budget balance even managing to show surpluses. They had a formidable team of technocrats and were the most accomplished and powerful of all government departments - a true centre of excellence. Successive upgrades of the sovereign credit rating resulted in SA achieving investment grade status.

The result of the 2007 ANC elective conference in Polokwane brought about a more populist political agenda, and the hard-won fiscal gains over the previous decade begin to erode. Thabo Mbeki was recalled as State President by the ANC in September 2008, co-incidentally the same month that Lehman Brothers collapsed, which also marked the low (best) point in the debt-to-GDP ratio. Following the 2009 National elections, Trevor Manuel vacated his position in favour of a more low-key role as Minister in the Presidency for the National Planning Commission.

This marked the end of an era, as the ensuing decade and a half has seen the reversal in the fortunes of both the policies and management of government finances. The credibility of the National Treasury is now left wanting as they have perennially over-promised and under-delivered. The political transformation saw the Treasury lose its coveted status within government and the highly skilled technocrats have long since left. At the time of the political shift, the government's debt ceiling stood at 50%, this then became 60% when they adopted the Southern African Development Community (SADC) average, whose average was boosted by the impact of Zimbabwe. The ratio stood at 72.7% as of 30 June 2023 and is widely expected to head even higher still.

One of the reasons for the poor macroeconomic policies adopted since 2008 was that the National Treasury (like the SARB) assumed that the potential growth rate of South Africa was 4.5%. They did not fully appreciate that the relatively high growth rates achieved in the lead-up to the Global Financial Crisis (GFC) were largely due to bubble conditions. The SARB at least realised the error of their ways in 2014 when they got a new Governor, but the Treasury only came around much later. Also, the writing was on the wall when the narrative used to justify easier fiscal policy in the aftermath of the GFC was that "the prior fiscal prudence created space to allow support for the economy during shocks". As the saying goes, when you give a finger, they will take the whole arm. It is for this very reason that South Africa should seriously consider creating an Office for Budget Responsibility (OBR) like the United Kingdom. An independent fiscal watchdog would have helped steer the fiscus in a better direction.

Graph 2: Foreign investors retreat from SA bonds

(Foreign holdings as a % of SA government bonds)

Source: M&G Investments, National Treasury

The 2017 MTBPS provided the most honest assessment of the state of the fiscus since 2009. The Treasury officials used the opportunity to highlight the plight of the fiscal situation for all and sundry to see. The severity of the bond market reaction to that MTBPS meant that we have not seen such an honest appraisal since. The rating agencies all rather belatedly cut South Africa's sovereign rating status to sub-investment grade, more colloquially known as "junk" status. Foreign investors who mainly entered the SA government bond market post the GFC endured the worst of the fiscal slippage and have now steadily retreated, with their proportion of SA government bond holdings declining from a peak of 42.8% during the "Ramaphoria" period in March 2018 down to a current level of 25.2% as at end September 2023, as shown in Graph 2.

Fiscal policy, in our view as fixed interest managers, remains the gravest threat to the South African economy. The SARB (now run by former National Treasury officials) has become very vocal in highlighting the need for fiscal prudence as the deteriorating fiscal situation places pressure on the rand exchange rate and ultimately inflation, which is what the SARB aims to control. The widely held expectation is for Wednesday's MTBPS to show lower revenues (declining mining sector profits), higher expenditure (civil service salary increases) and by implication a larger budget deficit for the current fiscal year. The risks surrounding National Health Insurance (NHI), Social Relief of Distress Grants (SRD Grant), the Basic Income Grant (BIG) and further support for ailing State Owned Companies (SOC's), all remain ever-present for the medium term. The most pressing issue for bond investors is whether the announcement of an increase in fixed-rate bond issuance is included in the MTBPS or delayed until the Budget Review next February.

Fixed income assets by their very nature are highly cyclical, susceptible to both domestic and global inflation and monetary policy cycles. However, the one constant over the past decade and a half has been the steady deterioration in SA's fiscal metrics. In managing the M&G Enhanced Income Fund, which has an absolute return focus, we are very mindful of drawdowns and have chosen to take our interest rate risk in the short end of the yield curve, which is more influenced by the credible monetary policies of the SARB than the long end, which is more susceptible to fiscal policy. This has shielded investors from the steepening of the yield curve and the underperformance of long-dated bonds. The investment horizon for the fund, at three years, also ties up with shorter-maturity assets. We are also very tactical in our positioning considering the cyclical nature of fixed income assets. No matter what the outcome of the 2023 MTBPS, the fund is positioned to weather a possible fiscal storm, mindful of protecting our clients' investments while capturing the best possible yields.

ENDS