Consider this

South Africa in one word: Commodities

January 2024

Bulent Badsha
Portfolio Manager

Some say that the success of the Springbok rugby team is South Africa's crowning sporting achievement, Table Mountain its signature tourist attraction, and Nelson Mandela its greatest son. However, that is only above the surface -- it is what lies beneath the country's surface that matters more from an economic and market perspective. In managing the M&G Enhanced Income Fund, we are fully aware that the economic fortunes of South Africa, as a small open economy, are inextricably linked to changing global economic conditions. This arises both from financial and trade linkages. Our trade with the rest of the world is dominated by commodities, with global supply and demand factors having profound effects on commodity prices and ultimately on our economy and financial markets. The passage of time has seen a decline in mining's direct contribution to economic output, and the composition of the products mined has changed as well. The boom-bust nature of commodity cycles has historically had a pronounced influence on South Africa's business cycle, and although this influence has waned over time, the impact of commodities remains ever present.

An outsized impact on SA investors through equities, the rand and bonds

According to Statistics South Africa's mining industry census of 2019, only four of the nine provinces produced almost 85% of sales: Mpumulanga, Limpopo, North West and the Northern Cape. The census also showed that only four types of mining generated almost 80% of income: coal, platinum group metals, iron ore and gold. Therefore, mining activity in only four provinces for only four types of commodities largely explains South Africa's total mining production. Yet this relatively limited activity has an outsized influence on SA investing, since it makes the domestic equity market resources-heavy. Meanwhile, resources companies are notoriously difficult to invest in as they are exposed not only to the vagaries of global commodity price cycles, but also to the volatility of the rand exchange rate. This makes the analysis of and positioning in resources shares a key determinant of local equity alpha generation for any portfolio benchmarked to SA equities. And it is not only the domestic equity market that is affected by commodities --the currency and bond markets are as well.

Looking at the rand, it is not only an emerging market currency, but also a high-yielding one. Furthermore, it is relatively liquid and a commodity currency too. This cocktail of risk factors makes it an especially volatile currency that is highly geared to the global risk environment. And given South Africa's high levels of crude oil and petroleum imports, the country's terms of trade (the ratio between export and import price indices, which helps drive the exchange rate) is largely a function of commodity prices. Movements in the rand have an influence on consumer price inflation and by implication the SARB repurchase rate, too.

Taking it another step further, commodity prices also have an outsized influence on government revenue via corporate income tax and mining royalties, which in turn affects the budget balance and, ultimately, bond supply. How the government manages its finances through the commodity price cycle is critical, as commodity price windfalls always in time reverse course to become curses.

Managing government finances through the ups and downs of commodity cycles

Post the advent of democracy in April 1994, the government debt-to-GDP ratio was relatively stable at around 43% until the turn of the century. In the aftermath of the Asian (1997) and Russian (1998) Financial Crises the local prime interest rate reached a record high of 25.5%. However, these bleak conditions set the stage for the longest recorded upward phase in the domestic business cycle, from September 1999 to November 2007. Following the Argentina crisis (2001) the currency strengthened, inflation moderated, and interest rates were reduced. This helped to fuel private sector credit extension growth of up to 25% per year, house prices rose appreciably as they did across the world, household debt to disposable income exploded and annual economic growth rates rose to more than 5%. It must be noted that this period broadly coincided with that of the 2000s commodities boom, when the prices of commodities rose aggressively from very depressed levels, and South Africa benefitted tremendously with an improvement in living standards due to the terms of trade shock.

The government debt-to-GDP ratio fell from around 42.9% in the second quarter (Q2) of 1999 to a record low of 23.5% in Q3 2008. While the efforts of the authorities to reduce the budget deficit over this period is undeniable, it must be acknowledged that it is much easier to conduct responsible fiscal policy in South Africa during a commodity price boom. The bubble conditions in the economy that prevailed over this time saw the South African Revenue Service rake in taxes far greater than those budgeted for, and the National Treasury even showed a budget surplus for two fiscal years. It would seem hard to believe currently, but the government was redeeming bonds on a net basis. However, the president expanded the number of government grants over this period in the face of opposition from the Finance Ministry. The onset of the Global Financial Crisis (2008) brought an abrupt end to the commodities boom and burst the South African growth bubble. The shift in leadership of the ruling party -- initially and then later the country -- led to more populist decisions with no regard for fiscal prudence.

There was a strong rebound in commodity prices in the aftermath of the Global Financial Crisis, but this was short lived as they struggled right into the Covid pandemic (2020). The intervening period saw economic growth largely stagnate as business and consumer confidence collapsed. Both monetary and fiscal policy were eased to support the economy, but failed to generate much traction and only dented institutional credibility. The failure of Eskom and the onset of loadshedding coupled with the emergence of state capture further dampened sentiment and investment spending. The Revenue Service was also systematically broken down. At the same time, a sharp rise in hiring in the civil service and large wage increases over this period created a permanent drag on the fiscus. The shift in political leadership and the arrival of a new Finance Minister encouraged the technocrats in the National Treasury to move to greener pastures at the South African Reserve Bank. Meanwhile, the government debt-to-GDP ratio rose steadily until the onset of the pandemic, reaching 57.1% in Q1 2020.

The Covid pandemic ushered in a slump in global economic activity and by implication, commodity prices as well. Government actions to curb the spread of the virus brought the economy to a grinding halt, thereby lowering tax revenue. This, combined with aggressive economic support measures for businesses and consumers, increased spending, bringing about the most rapid deterioration in government finances seen, which in turn necessitated an increase in government bond supply. At the very same time, Moody's downgraded South Africa to junk status and the country's bonds were removed from the World Government Bond Index (WGBI), causing foreign investors to flee from the domestic bond market.

As luck would have it, the global economic rebound out of the Covid pandemic starting in the second half of 2020 was strong, accompanied by an insatiable demand for the commodities that South Africa produces. This helped to boost economic growth, increase government revenues by much more than expected, reduce bond issuance and lower the debt-to-GDP ratio. Unfortunately, this windfall proved short lived, and the gains were largely squandered. In fact, the National Treasury assumed there was a permanence to this abundance and included the higher revenues in their medium-term budget framework but they have had to reverse course since.

Today, with commodity prices broadly lower, the institutional failures of Eskom, and now even more importantly Transnet, are hampering SA resource producers in their ability to export commodities to the rest of the world. This deprives the country of much-needed export revenues and tax receipts. South Africa is blessed to be heavily endowed with natural resources, and its economy, government finances and markets are very sensitive to commodity prices. As investors, we should always be mindful that commodity prices are highly cyclical, and booms do eventually turn into busts. Like the government, SA investors should aim to be prudent in managing their money during times of plenty to provide a cushion during downturns. In managing the M&G Enhanced Income Fund we are not only cyclically aware and tactically alert, but also drawdown focussed.