South Africa: Reaffirming the tedious reform course

The elections in South Africa is likely to see African National Congress at the helm again which markets should consider a positive, but party unity and union support is a hurdle for reform implementation and clouds the medium-term outlook. Without a doubt, we think politics will continue to remain an important driver for South African assets

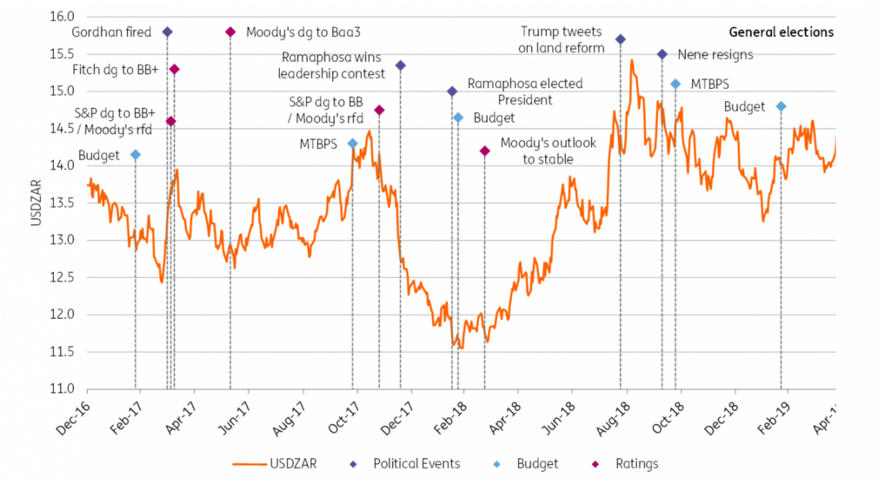
South African president Cyril Ramaphosa (C) dances with Minister of Education, Naledi Pandor (R) and ANC Western Cape provincial election leader Ebrahim Rasool (L) whilst on the campaign trail before general elections on 8 May 2019

Source: Shutterstock

Ahead of general elections on 8 May, there is a consensus that a strong mandate would give Cyril Ramaphosa's cabinet a helping hand in fighting graft and reviving the economy. Unless the African National Congress (ANC) is in for a negative surprise, markets will likely take the election outcome as a positive which could be further underpinned by timely and credible reform announcements.

However, the necessity for party unity and union support is a hurdle for reform implementation and clouds the medium-term outlook. Without a doubt, political dynamics will continue to remain an important driver for South African assets.

Domestic political cycle is a key driver for the rand



Source: Bloomberg, ING

Hopes and fears lie with ANC's support in the national elections

On 8 May, national and provincial elections will take place in South Africa with a particular focus on the former. In conversations with clients, we found that investors are hopeful for the ruling African National Congress to secure a strong mandate in the National Assembly which would enable President Cyril Ramaphosa's new cabinet to implement much-needed reforms and increase momentum in the fight against corruption during the next five-year period. In a more adverse scenario, concerns are that less market-friendly factions in the ANC would challenge the leadership, given Ramaphosa's narrow victory in the party's leadership contest in end-2017.

While support for the ANC has continuously fallen since the 2004 general elections (69.7%), opinion polling results suggest a strong lead for the ANC ahead of opposition parties. However, two most recent polls vary substantially with Ipsos still seeing support around 61% while the South African Institute of Race Relations' (IRR) poll indicates support at a more perilous 50-51%.

Opinion polling for South African general elections and past results

Pollster	Release	Participants	Turnout Scenarios	ANC	DA	EFF
IRR	30/04/2019	2,375 between 18-25 Apr	100%	49.5%	21.3%	14.9%
			69.3%	50%	24%	14%
			71.9%	51%	24%	14%
Ipsos	29/04/2019	3,600 between 22 Mar-17 Apr	100%	56.9%	15.2%	9.5%
			71%	61%	19%	11%
eNCA Markdata	22/04/2019	3,058 between 15 Feb-12Mar	excl. uncertain voters	59.0%	21.3%	12.1%
Ipsos	19/03/2019	3,511 between 1 Feb-4 Mar	100%	61%	16%	9%
			80%	61%	18%	10%
IRR	06/03/2019	1,611 between 12-26 Feb	100%	54.7%	21.8%	12.2%
			71%	55%	24%	11%
2014 Elections	07/05/2014		73%	62.1%	22.2%	6.3%
2009 Elections	22/04/2009		77%	65.9%	16.7%	-

Source: IEC, eNCA Markdata, Ipsos, IRR, ING

The IRR believes that a combination of factors (ongoing graft allegations, load shedding, protests and lacklustre campaigning) have had some impact on the recent figures. Also, the last few years have seen voter disillusion with many believing that there is no party that represents their views (37% according to Ipsos) and instead considering protests as acceptable to voice their dissatisfaction about the standard of services (42%).

Talking about elephants in the room but barrier to reforms are high

Some reform steps have already been initiated during Ramaphosa's tenure since February 2018 with regard to economic growth (securing c.$21bn in investment pledges during Investment Conference 2018), fiscal transparency (increased budget credibility however at the cost of higher expected debt burden), contingent liabilities (notably support measures for Eskom) and governance (replacement of SOE management and boards, public prosecutor and tax agency).

However, those measures represent small steps which remain insufficient to lift growth and stabilise the public debt. Uncertainties weighing on growth include land reform, electricity shortages, concerns about corruption as well as the combination of high unemployment, which was 27.1% at the end of 2018 and skill shortages.

2019 Budget: Growth, inflation and current account balance outlook

A: Actual / E: Estimate / F: Forecast

	2017A	2018E	2019F	2020F	2021F
Real GDP growth	1.3%	0.7%	1.5%	1.7%	2.1%
CPI inflation	5.3%	4.7%	5.2%	5.4%	5.4%
Current account balance (% of GDP)	-2.4%	-3.5%	-3.4%	-3.8%	-4.0%

Source: National Treasury (2019 Budget), ING

Consequently, low growth (+0.8% in 2018) weighs on tax collection and the denominator in public debt to GDP (55.6% in 2018/19), with the latter expected only to stabilise around 60.2% in 2023/24. Moreover, contingent liabilities continue to pose a burden (17% of GDP in 2018/19), reflected by the announcement of ZAR 23 billion (0.4% of 2019 GDP) in annual capital transfers to Eskom over the next three years.

2019 Budget: Fiscal outlook

A: Actual / E: Estimate / F: Forecast

	2017/18A	2018/19E	2019/20F	2020/21F	2021/22F
Revenue (% of GDP)	28.7%	28.8%	29.3%	29.2%	29.4%
Expenditure (% of GDP)	32.7%	32.9%	33.7%	33.5%	33.4%
Budget balance (% of GDP)	-4.0%	-4.2%	-4.5%	-4.3%	-4.0%
Gross debt (% of GDP)	52.7%	55.6%	56.2%	57.8%	58.9%
Net debt (% of GDP)	47.9%	49.9%	52.3%	54.1%	55.5%

Source: National Treasury (2019 Budget), ING

Absent of an unexpectedly weak result, we could see a lift in confidence in the short-term following the 8 May elections. We expect the government to reaffirm its reform commitment after the elections and also note that Public Enterprises Minister Pravin Gordhan has announced to elaborate on potential solutions with regard to Eskom around the elections.

However, optimism is likely to be more contained due to:

- **ANC internal policies and governance**: The ANC's leadership contest in December 2017 had seen Ramaphosa winning only narrowly against Dlamini-Zuma (2,440 vs 2,261 votes). Thus, the party leadership is walking on a tightrope, on the one hand tackling graft within the party and on the other sustaining party unity. The state capture and related investigations have brought down several politicians and resulted in changes in SOE boards. Nonetheless, some party members inflicted in graft allegations remain in powerful positions while there is also a risk that more reputable figures are affected in some way (notably with ex-FinMin Nhlanhla Nene stepping down in October 2018). With regard to the next cabinet, we can expect the inclusion of policymakers from different factions, in line with the list of parliamentary candidates.
- **Opposition to economic and fiscal reforms**: Key reforms such as cutting costs in the government wage bill and Eskom's separation into three units face huge barriers. The unions, notably the Congress of South African Trade Unions (COSATU), have put their weight behind Ramaphosa but have stalwartly opposed any initiatives that could see job losses with remaining stubbornly high at 27.1%.
- **Populist policies**: While the government gazetted the final Mining Charter in Sep 2018, land reform remains a daunting process. Ramaphosa has vowed in favour of these, however pledged that expropriations would be limited to some circumstances (no "land grabs") and only if they don't damage output. Nonetheless, a solution remains distant. Moreover, the ANC has also pledged to nationalise the SARB with parts of the ANC having gone further to demand a change in the bank's mandate.

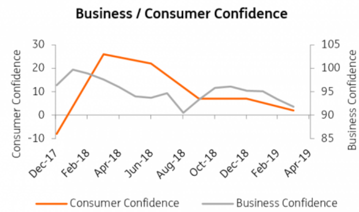
All in all, the necessity for party unity and union backing means that reforms in South Africa will remain slow-paced, no matter the ANC's strength in the national ballot. Moreover, the government and economy will continue to face occasional setbacks in tackling the economic and fiscal challenges. Looking for a comparable case, we believe that Brazil serves as a reminder that political risks remain high and reform success cannot be taken granted even with a "market-friendly" candidate as pension reform efforts stall.

Institutional strength bodes well for confidence after elections

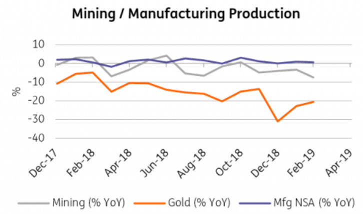
Different from early 2018 when euphoria after the change in the presidency quickly dissipated, we believe that investors are more cognisant of the hurdles this time. Even more, we think that bilateral/multilateral stakeholders, rating agencies and investors will remain supportive of South Africa's reform course because it is the one and only alternative following the economic standstill over the last decade.

Most importantly, what sets South Africa apart from many other emerging markets is the strong willingness of the government, further bolstered by the National Treasury's and Reserve Bank's reputation, to bring the economy back on track and attract investments.

Undeniably, the possibility of both extremes, narrow simple majority (50%) and undisputed dominance (>60%), implies an immediate and meaningful market risk. However, assuming that the truth lies somewhere in between, we would give the new government the benefit of doubt and expect the government to swiftly focus on the ongoing economic challenges, notably raising growth and limit the fiscal burden. In turn, this should bode well for confidence and create a foundation for investments. The stabilisation of South Africa's Ease of Doing Business ranking is a (still distant) light at the end of the tunnel.



Source: BER, SACCI, Bloomberg, ING

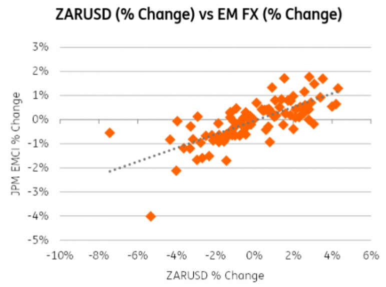


Source: Statistics South Africa, Bloomberg, ING

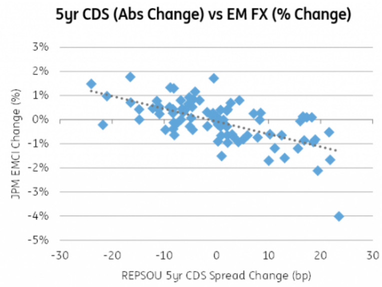
South African assets remain a sentiment play with a political twist

On the one hand, the rand and credit are highly correlated with the wider market but on the other hand, political risk has run its own cycles.

Both, the rand and South African credit have a high correlation with indices for emerging market currencies. The charts below graphically indicate a strong relationship between the J.P. Morgan Emerging Markets Currency Index and the South African rand (0.75 correlation) and CDS (-0.62), respectively, using weekly data since 2017.



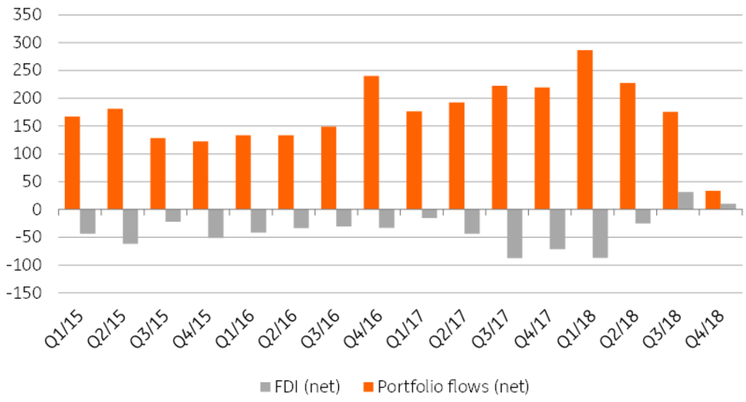
Source: Bloomberg, ING – based on weekly data since 2017



Source: Bloomberg, ING – based on weekly data since 2017

This reflects the nature of the rand as one of the most traded currencies in EM and high non-residential involvement in government debt (37.7% at end-2018 for domestic government debt). Figure 8 also highlights the country's large dependence on portfolio flows given the persistent current account deficits in the 3.5-4% range. According to the Institute of International Finance, their model considers South Africa as most over-positioned within EM. This leaves South Africa vulnerable to a turn in investor sentiment and also to idiosyncratic factors such as a potential downgrade by Moody's.

Net FDI / Portfolio Flows (12 month rolling basis)



Source: South African Reserve Bank, ING

Meanwhile, FX reserves are relatively low, standing at only $49.7 billion, covering just below 100% of short-term external financing needs, however, other factors are supportive.

First, South Africa is a net external creditor (positive NIIP). Second, government and corporates tend to borrow in ZAR (only half of the external debt is FX-denominated), reducing the rand depreciation impact on reserves and balance sheets. Lastly, exchange controls reduce outflows by residents (to R2 million per person) and corporates/banks (24% of total liabilities) to some extent.

Beyond external market forces, politics remain a key driver for South African assets. As we've shown above, Gordhan's dismissal as FinMin in March 2017 has seen knee-jerk sell-offs and so have the Medium Term Budget Policy Statements in 2017 and 2018. Often, those events were followed by rating downgrades.

In contrast, in anticipation of the political transition within the ANC and for the presidency, we saw a strong rand rally through November 2017 until February 2018 when ex-president Zuma resigned.