MTBPS: no real plan; implications for SA financial assets

RESEARCH

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Margaret Thatcher famously quipped that the problem with socialism is that you eventually run out of somebody else's money to spend. The MTBPS yesterday was both an acknowledgement that our government has lost control of finances and that we are rapidly running out of other people's money. The problem in South Africa is arguably not so much about socialism, but more about an excessive government payroll that is mired in inefficiency and corruption. These factors have all combined to crowd out the private sector and dominate the economy. The inevitable slow economic growth was exacerbated by a collapse in confidence by consumers and business on the back of the cabinet reshuffle to remove Pravin Gordhan.

South Africa's budget is increasingly allocated towards the wage bill, social grants and interest payments, leaving little in the way of funding for productive infrastructure necessary to lift South Africa out of its capacity-constrained growth environment. This is the slow growth trap that we have been warning about for a while.

Government seems to have acknowledged that raising taxes is counterproductive. The mood in the country is strongly negative towards the government and tax hikes will likely see a further decline in compliance and further social unrest. SA is close to peak taxes as a proportion of GDP. Given that the government does not want to cut spending and cannot raise taxes, then the only option is to increase borrowings. Arguably a lack of understanding of financial markets means that the government has overestimated the enthusiasm that the markets will have to fund government excesses.

The most stark aspect of yesterday's MTBPS was the plan to run a deficit of 3.9% per year going forward. In an economy that grows at a rate of anywhere between 1% and 2% per year, we would expect that debt will accumulate at a rate of between 2% and 3% of GDP per annum. Put simply, this is not sustainable. There was no attempt in the MTBPS to explain how Treasury will bring the deficit under control, or even stabilize the situation, but rather it appears it has merely been assumed that government can continue to accumulate an extra 2% of debt per annum without a meaningful deterioration in the cost of funding.

The reaction is obvious. The open acknowledgement by government that we cannot stabilize our demand for debt means that the rating agencies should respond swiftly. The absence of any credible plan to manage this situation means that the quality of our treasury and finance ministry should be questioned. The rating agencies should be expected to take a dim view of the loss of control of our finances, the high debt load and the poor quality of the response by treasury. We should expect that downgrades are inevitable and should pull our expectations forward. It is highly unlikely that we will retain our current ratings for the next 12 months. We need to adjust our base case to be that South Africa will be kicked out of the WGBI government bond index. The expectation should be that rates will gravitate towards 10.25% and the Rand towards 15.00 at some point over the next year. Perhaps, if the agencies move at the end of November we will see the ANC conference taking place in the backdrop of the economic mayhem that is likely to follow the downgrades.

We include the below table with the Debt to GDP levels of all countries rated BB+ (our current rating). Note how we are rapidly becoming an outlier in the BB+ countries. The target Debt to GDP level of 61% with no plan to stabilize this is a problem. This should nudge the rating agencies to move sooner rather than later

Countries with BB+ Rating by S&P

Country	Debt/GDP
Cyprus	108.00%
Bahamas	77.90%
SA	51.70%
Azerbaijan	37.70%
Oman	31.40%
Bulgaria	25.40%
Russia	17.00%

Source: Anchor Capital

For now, the government remains oblivious to the situation. We note with concern the press release from the ANC congratulating the Finance Minister on the budget and prioritizing social spend and transformation over fiscal prudence. With no growth, there will be no transformation. Without the current credit ratings, the risk of a failed government bond auction is quite high. The market will soon say no more.

MTBPS: no real plan

Implications for SA financial assets

Implications for SA fixed income & Anchor's positioning

In this context, we have no choice, but to be negative on South African duration assets. We should be underweight bonds and are focusing on the right exit rather than opportunities to buy. There is no reason to rush for the exits, the R186 yield is 9.37% at the time of writing. A real yield of 4.4% means that we have now matched the cheapness of bonds achieved by Brazil towards the height of their crises. Without a change in direction of policy (we can safely conclude that the policies of the last decade have failed) we do not see a reason to hold long dated bonds. Our portfolios were already very underweight duration and we expect that we will further reduce exposure in coming days and weeks. Our base case scenario now incorporates further downgrades from S&P and Moody's, and an exit from the Citigroup World Government Bond Index (WGBI). This event should trigger by our estimates approximately R100bn of forced bond sales, and likely results in our R186 (10 year) bond yield pushing out to 10%+ yields.

In stark contrast, our Anchor BCI Flexible Income Fund just became a whole lot more attractive. The yield on the portfolio is going up, and with no prospect of an interest rate cut in South Africa any time soon investors will earn more going forward. The portfolio remains managed for stability of valuation and will in the midst of all this still report gains for the month.

Implications for SA equities and Anchor's positioning

We have at length commented about the construct of the SA equity market comprising significant Rand hedge exposure (>50% by value), so we will not repeat this analysis here. The greater debate for SA equity investors recently has been wrestling with two key contrasting risks.

The first one could come in the form of the ANC policy conference possibly resembling a "Brazil moment" (in a good way) should Ramaphosa emerge victorious (subjectively, a higher probability outcome than Dlamini-Zuma, the "low-road" candidate) – this in itself would likely lead to significant rally in "risk" assets such as Banks, Retailers and listed property on the expectation that structural reform could follow.

The second opposing risk which we have recently highlighted in our Q4 strategy is the perilous fiscal position South Africa currently finds itself in. While the absolute quantum of the revenue shortfall should not have been met with surprise by anybody, what is unequivocally negative versus our expectations is the lack of any plan presented to deal with the issue, with Treasury seemingly abandoning the idea of fiscal consolidation in favour of further bond issuance. To our minds, this has materially raised the odds of SA remaining firmly on a low-road economic path versus what we would have previously expected.

Our portfolio positioning has attempted to strike a balance between these two factors, dictating that while we – on balance – retain a global (Rand hedge) bias to our equity funds, it is too risky to have no exposure to "risk on" assets in the form of SA banks and retailers . This budget, by itself, lowers the probability of a very strong performance from these SA assets, with the impact being felt most acutely via a compression of valuation multiples in a scenario of bond yields stretching to 10% and beyond.

As a result, we have trimmed our exposure to Banks and Retailers following this budget and allocated the difference to Rand hedge counters such as Bidcorp and Astoria.

The table below shows a sensitivity to our Banks valuations assuming a bond yield of 10% (as a starting point in building out a valuation model) - this highlights downside risk should this scenario play out. It should be noted that Banks are the equity sector class most sensitive to changes in long term interest rates. We are now underweight Banks in our equity CIS funds and believe our portfolio positioning is consistent with a continued depreciation of the Rand and sell-off of fixed income yields.

Figure 2: Banks fair value estimate under a scenario of 10% 10 year bond yield

	Spot	Fair value	Implied P/BV (FY17)	% downside
Firstrand	51.1	41.5	2.1	-19%
Barclays Africa	137.6	118.4	1.0	-14%
Nedbank	205.0	166.4	1.0	-19%
Standard Bank	159.8	114.7	1.13	-28%

Source: Anchor Capital