CYCLICAL RECOVERY ON THE WAY

The US Federal Reserve Bank has embarked on a cycle of interest rate hikes. How will successive Fed rate hikes affect the rand and South African bond and equity prices? During the last Fed tightening cycle between June 2004 and June 2006, the rand depreciated by 17% versus the US dollar from R/$6.14 to 7.18. However, the ten-year bond yield firmed from over 9% to under 8% while the All Share Index more than doubled from 10,109 to 21,238. The Fed tightening cycle is likely to be strongly positive for the JSE. Like most cycles this Fed hiking cycle coincides with an acceleration in global economic growth, firming in commodity prices and increasing demand for emerging market exports.

Fed hiking cycle points to likely JSE gains

![Graph showing the relationship between JSE ALSI and Federal Funds effective rate (%).]

GDP growth has been on a declining trend since 2011. In 2016, South Africa succumbed to the perfect storm with year-on-year growth of just 0.3%. GDP growth was undermined by accelerating inflation, rising interest rates, declining consumer spending, slowing mining and manufacturing demand, the impact of political uncertainty on business confidence and one of the worst droughts in living memory. However, notwithstanding the loss of our foreign currency investment grade credit rating GDP growth will rebound in 2017 and 2018.

The South African Reserve Bank’s leading economic indicator, which predicts economic conditions 3-6 months ahead, increased in February for a seventh consecutive month, signalling a significant recovery in economic growth. The impressive increase reflects a rebound in both external and domestic conditions. External conditions are improving as a direct consequence of the steady recovery in the global economy. According to the World
Trade Organisation the world economy is enjoying synchronised growth across all regions for the first time since the global financial crisis in 2008/09. Amid rising international commodity prices and strengthening global trade South Africa’s trade balance has improved from a trade deficit of -R6.6 billion in the third quarter 2016 to a trade surplus of +R55.7 billion in the fourth quarter. Our current account deficit has narrowed steadily from -5.8% of GDP in 2013 to an impressive -1.7% its lowest level since the second quarter of 2011.

Domestic conditions are also improving. Following one of the worst droughts in living memory agricultural conditions will bounce back this year as weather patterns normalise. The US Department of Agriculture forecasts South Africa’s maize output will increase in 2017 by 65% more than reversing the 27% decline in late 2015 and early 2016. After years in the doldrums manufacturing activity is finally turning the corner. The Stellenbosch-based Bureau of Economic Research purchasing managers’ index (PMI), a forward-looking survey of conditions in the manufacturing sector, has risen sustainably above the expansionary 50-level. For the first time since March 2012 all major PMI sub-indices are above the 50-level. The South African Chamber of Commerce and Industry’s (SACCI) business sentiment index has risen to its highest since October 2015.

There is a cyclical recovery underway with businesses and households starting to renew durable goods purchases. This is best reflected in vehicle sales figures. In the first quarter of this year total vehicle sales increased by 1.9% year-on-year, the first quarterly gain since the fourth quarter 2014 with commercial vehicles rising by an impressive 4.2%. Although the latest credit figures show that annual credit growth remains weak at 5.3%, credit to companies is expanding at a robust 10.6% year-on-year rate.

Sub-Saharan Africa is enjoying a solid economic recovery. The neighbouring region accounts for 30% of South Africa’s total exports and an even greater proportion of manufacturing exports, making it the country’s largest export destination. The strong recovery in Sub-Saharan Africa is good news for South Africa’s economy. Following growth of just 0.7% in 2016 GDP in the region is expected to expand in 2017 by 3.5% accelerating to 4.0% in 2018 amid rising international commodity prices and normalisation of weather patterns, in turn boosting agricultural output and hydroelectricity generation.

The Reserve Bank has hinted that the interest rate hiking cycle is ended, suggesting that the repo rate, after rising from 5% in early 2013 to 7% currently, is likely to ease in coming months. Food price inflation is expected to reverse course in 2017, falling sharply in line with increased agricultural production, in turn bringing down CPI, which is expected to average 5.5% over 2017. This is well within the Reserve Bank’s target range of 3-6%, which despite recent rand turbulence should embolden the central bank to cut interest rates. Interest rate cuts will boost consumer and business confidence, household expenditure and investment spending.
Forecast for South Africa’s economy have become overly pessimistic. Despite rising political risk the cyclical economic rebound will take many by surprise fuelled by a recovery in agriculture, manufacturing and mining, falling interest rates and increased business and household spending. The domestic economy is in the very early stages of a cyclical recovery. GDP growth will rebound in 2017 and 2018, potentially by more than currently projected. GDP growth of 1.5% is likely in 2017 as the negative conditions which beset the economy in 2016 begin to reverse.

President Zuma’s unwelcome changes to the Cabinet and the National Treasury have escalated the level of political uncertainty. However, there is growing hope that these seismic events will force an early and constructive shift in leadership in the ANC. A change in leadership could provide the catalyst for bringing about the much needed structural reforms required to lift South Africa’s economy from a mere cyclical upturn to a prolonged secular recovery.

The JSE All Share has recorded a meagre 8% return over the past three years, equivalent to less than 3% annualised. This does not compare favourably with inflation at over 6% and money market returns of around 8%. Yet, equity markets are forward-looking and so investors will be rewarded handsomely for investing during the very early stages of the cyclical recovery and even more so if South Africa enters a prolonged period of above average secular growth.