

When Does South Africa Exit Recession? (Part II) – Market Commentary

April saw another strong month in developed markets with the S&P 500 returning +1.5% to reach +9.0% for the year-to-date vs the Nasdaq at +21.4%. It certainly does not appear that the US markets, and the Nasdaq in particular, are expecting a US recession.

Emerging markets underperformed at -1.1% for a +2.8% return for the year-to-date, while South Africa, perhaps surprisingly, performed better than average within Emerging Markets with a +0.3% return in USD terms, inclusive of a +3.1% USDZAR depreciation.

We note also that the MSCI World Index is performing marginally better than the US market. European markets have outperformed the US so far this year e.g. the UK, Switzerland etc, however since the US comprises nearly 70% of the MSCI World and drives this global benchmark, the MSCI World is only slightly ahead of the US.

The various returns are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for March 2023*

	Apr-23	YTD 2023
FTSE/JSE ALSI (ZAR)	3.4%	8.7%
FTSE/JSE ALSI (USD)	0.3%	1.2%
MSCI World	1.8%	9.6%
MSCI EM	-1.1%	2.8%
MSCI Value	1.9%	2.8%
MSCI Growth	1.6%	16.9%
S&P 500	1.5%	9.0%
Nasdaq 100	0.5%	21.4%

*Total return indices, Source: Factset

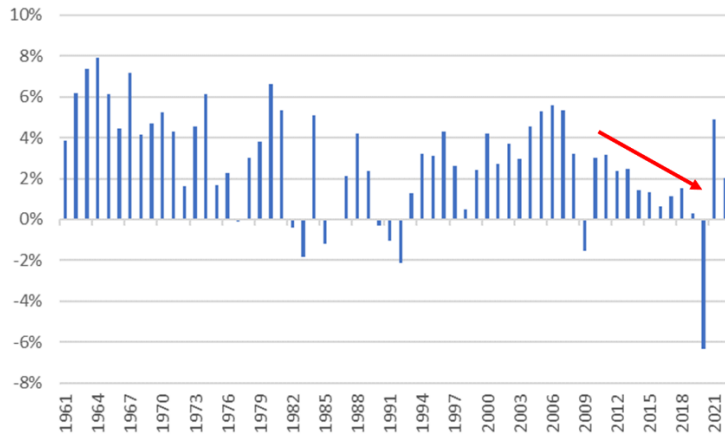
South Africa's electricity supply constraints are materially impacting prospects for economic growth. This, together with the current state of global geopolitics and the country's international relations, appear to be driving a weaker currency.

Yet South Africa's economy has been underperforming for many years. We suggest here that international relations may be a transient factor, and while electricity constraints have existed for some time, these have not been a decisive factor historically and have only recently become a real hindrance. Instead we consider conventional macroeconomics and the powerful effects of over-indebtedness. We suggest the economy has still not recovered from the financial crisis in 2008/2009 and this continues to be a primary driver of underperformance. The theme appears to receive significantly less attention than it merits. We discussed this in February 2022 and provide an update here.

Structurally lower economic growth

Chart 1 below sets out South Africa's real growth rate p.a. since 1960. The declining trend since 2009 is pronounced and readily observed up to the Covid crisis. While the growth rate appears to have recovered strongly in the last 2 years we note that this is a recovery from the Covid declines and the absolute value of real GDP has only recently recovered to pre-Covid levels i.e. there is no new growth, and with an overall flat trend.

Chart 1. South Africa real economic growth p.a.



Source: St Louis Fed, FRED

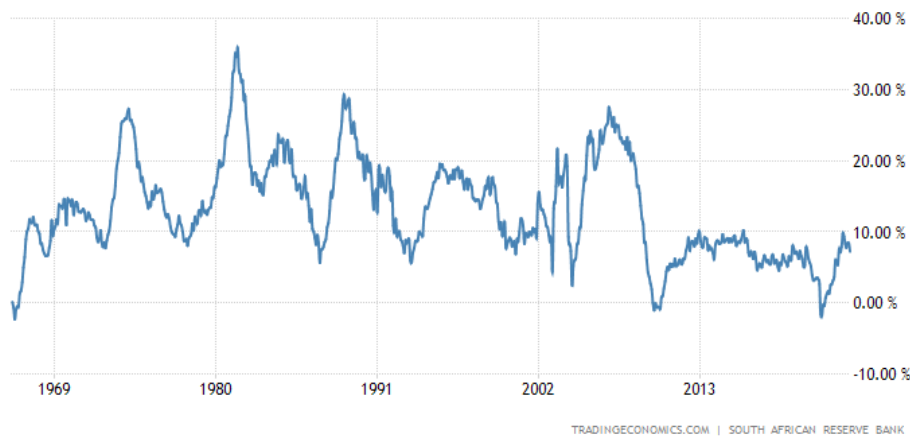
Electricity constraints have been present since 2008 and the much-criticised previous administration was in power from 2007 to early 2018. Yet we believe that while these were contributing factors they were not by themselves sufficient to create the observed deteriorating performance. Could something else be behind the trend?

Credit extension

A clue lies in some debt metrics. Debt can comprise up to 90% or more of money in circulation. Credit extension by banks, which is broadly demand-driven, is therefore a good indicator of spending in the economy.

With this in mind we consider bank credit extension in Chart 2 below.

Chart 2. South Africa private sector credit extension annual percentage change



Source: www.tradingeconomics.com

The cyclical nature of credit extension is clearly apparent in Chart 2 above. This is consistent with business cycles and historically in times of recession the rate dips below 10% p.a. The impact of the financial crisis in 2008 is also clearly evident with credit extension reaching 0%.

Following the financial crisis the cyclicality breaks and the rate settles permanently below 10% p.a. for the next decade, at a level consistent with prior recessions, until Covid arrives and the next crisis ensues.

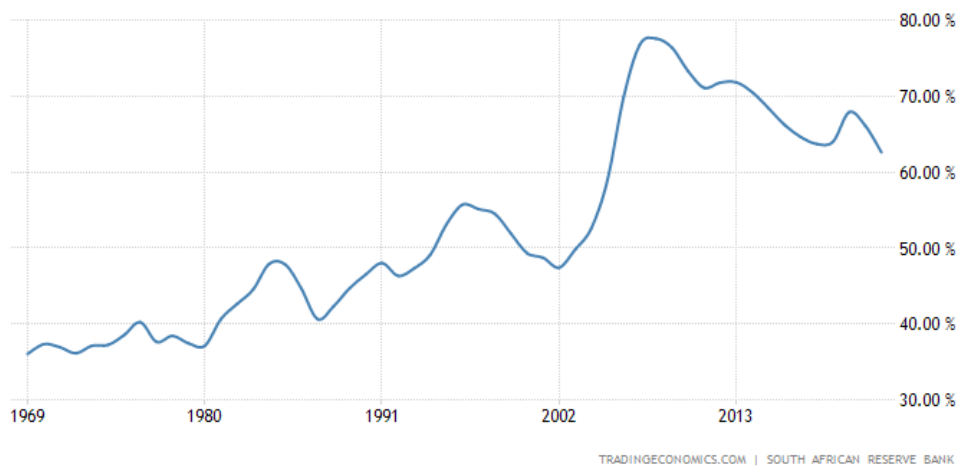
Credit extension currently remains below 10% p.a.

We suggest the level of indebtedness and the need to repay debts, and to not incur new debts, are the primary driver of the suppressed level of credit extension. Electricity supply constraints and maladministration are undoubtedly contributing factors but by far not the primary cause of a lost decade.

Too high a debt load

Chart 3 below presents household debt to income levels.

Chart 3. South Africa household debt to income



Source: www.tradingeconomics.com

The steep increase in leverage from under 50% in 2002 to almost 80% in 2007 is clear. For those who remember, this was a time of abundant liquidity (emanating from the US), economic growth not seen in decades, rising commodity and house prices, and buoyant stock markets.

Of course it all came to a crashing end with the financial crisis – commodity and stock markets declined, and South African house prices have not seen significant increases in 15 years, also missing out on the Covid real estate boom seen in many markets around the world (this latter we see as inflationary and reverting to pre-Covid, much like more liquid stock markets which already retraced in 2022). The leverage, however, remained, and this has to be paid back, or at least not increased further.

And so what we have had for 15 years is a slow deleveraging cycle where much of spending is directed to reducing debt rather than to goods and services. Lack of electricity supply and maladministration have had little to do with this.

How long?

Prospects for improvement are not encouraging. While progress has been made the debt to income is still above 60%, with the pace of deleveraging briefly reversing through the Covid difficulties. Historical reference suggests 50-60% could be a level where some stability materialises. At the same time the current interest rate increases do not help and

electricity supply constraints have entered a new phase of material impact on company costs and economic growth. We expect more difficulties ahead.