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NEWSLETTER

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ECONOMIC COMMENTARY - By Francois Stofberg

Fitch and the Fed

On Friday, Fitch affirmed South Africa (SA)'s sovereign credit rating at junk, with a stable outlook. The rating is supported by a favourable government debt structure (only having 9% of our debt exposed to foreign currencies), deep local capital markets (liquid and highly demanded), a healthy banking sector and strong institutions. They kept SA's growth projection for 2018 at 1.7% in which case the following quarters would all have to be in the very high 2%-range (something we believe is not quite possible). A more realistic outlook would be about 1.4%.

Fitch applauded the changes made at state-owned enterprises (SOEs), but agree with our view that the financial challenges at the institutions are severe. Most notable are the challenges at South African Airways and Eskom, our two bottomless pits of hard earned tax money. Eskom has already used R275 billion of the allotted R350 billion in government guarantees. Those same financial challenges at Eskom are the very reason we now again have load shedding.

Eskom's leadership tried to act like a bold private institution when it decided to cut both its capital and operational budgets with R10 billion, to improve its financial position. What was even bolder, or perhaps stupid in this case, was their decision to announce a 0% wage increase in 2018. Especially when one considers SA's nasty wage dispute environment and in context of the initial 15% request from trade unions. This abrupt shift in strategy might have been a bit too much for an SOE that hasn't been run like a healthy private organisation since 2001, when it was awarded the prestigious "global energy utility of the year". Some might even argue that Eskom hasn't been run well since the 1990's.

SOEs in general are plagued by a culture of unhealthy, bloated wage bills (at Eskom the number of senior managers has grown from 80 in 2001 to about 500 in 2017) and deep structural inefficiencies, which makes such a bold move seem a bit absurd. A better strategy, that considers the inability of government to fire people (which is one of the key structural issues keeping SA's economy from growing), might have been not to employ more people in 2018 and kind of force those already employed to be a bit more efficient.

Important global news was the decision by the US Fed to increase interest rates for the second time this year, as well as the European Central Bank (ECB)'s dovish tone towards rate hikes in Europe. The US Fed increased short-term interest rates to a range of 1.75% to 2.0%. What is even more important is that markets are now expecting a further two increases in 2018. Initially, we thought the Americans would be lucky to reach three, but at the rate at which the US economy is steam-rolling past everyone, four seems like a necessity. Contrary to our thoughts, the US economy has been able to print one good report after the other; from employment and jobless claims, to sales and earnings figures.

Just as the tech-titans stopped catapulting wealth on the stock markets, small companies stepped up to the task. Many believe, and statistics has proven, that small enterprises are the heart of a country's employment and wealth creation. Currently, the small business index in the US is in line with 40-year highs. At this rate, it seems more likely that the US has entered another golden-era than the chances are of them hitting another recession.

The president of the ECB, Mario Draghi, gave more dovish guidance to the end of quantitative easing (QE) in the European Union (EU). He explained that at the current rate, QE would end in 2018 but the first rate-hike will most likely only be in mid-2019. In all likelihood, it appears the EU will struggle to keep to their growth and inflation targets. Spain, Italy and Greece continue to provide a lot of headwinds. The result may be even further delays to real monetary tightening.