SOUTH AFRICA'S PATH TO SUSTAINABLE ECONOMIC GROWTH

NAVIGATING POLITICAL REFORMS AND ENERGY STABILITY

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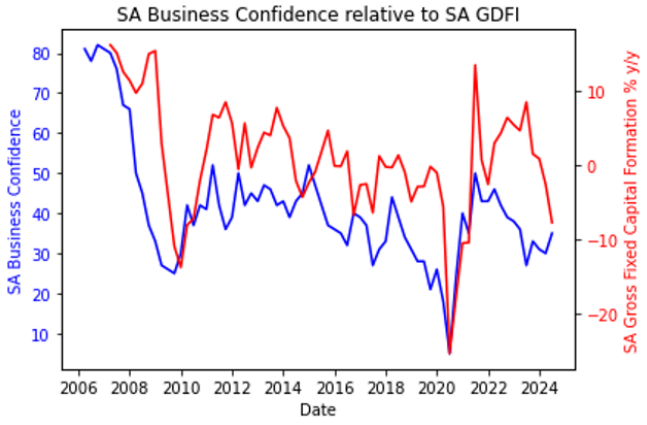
More than 100 days have passed since a successful and peaceful election process, which has left South Africa's financial markets poised for significant growth due to recent political and economic developments. Among the positive developments have been the announcement of a Government of National Unity (GNU), the cessation of load shedding, imminent SARB interest rate cuts, and the introduction of the two-pot retirement system.

Post-election economic surge

The formation of the GNU forebodes further political stability, fostering investor confidence and attracting both foreign and local direct gross fixed investment.



Source: Bloomberg, Investec estimates

It has also significantly increased business confidence and overall positive sentiment in the financial markets. The chart above shows a meaningful correlation between business confidence and gross capital formation, which could drive South Africa's GDP expansion towards a 2% growth rate.

Business confidence and infrastructure opportunities

To date, South Africa has a significant infrastructure backlog, particularly at Transnet Freight Rail, Eskom Transmission, and renewable energy projects. The capital expenditure required at Transnet to maintain its rolling stock is estimated at R200 billion.

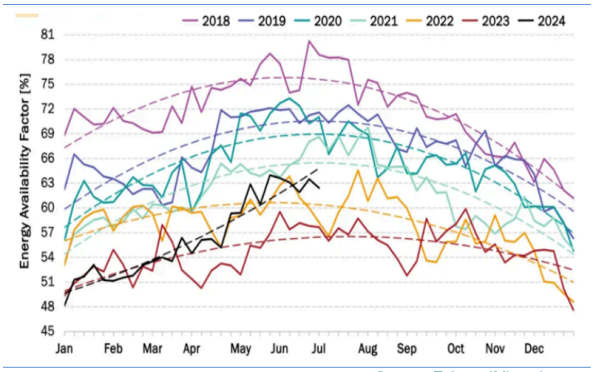
At the same time, the Eskom grid expansion and renewable energy work are set to demand R200 billion and R390 billion, respectively. This backlog of infrastructure build totals R790 billion (11% of SA GDP) to be spent over the next ten years. It presents a significant opportunity not only for job creation and, ultimately, for consumption spending perspectives but also increases the opportunity set for the banking industry for financing services.

"A significant infrastructure backlog presents a R790bn opportunity for job creation and economic growth."

Eskom's improved performance and impact on growth

Eskom's performance has also been another factor which has turned markedly positive in the current election period.

In 2023, Eskom had its worst performance since 2018, with an energy availability factor of 56%, a significant decrease from 62% in 2022 and 64% in 2021. The severe energy constraints resulted in unembellished challenges for consumer activity and business profitability as businesses were required to shoulder large diesel and alternative energy costs, constraining operating margins and profitability.



Source: Eskom, IML estimates

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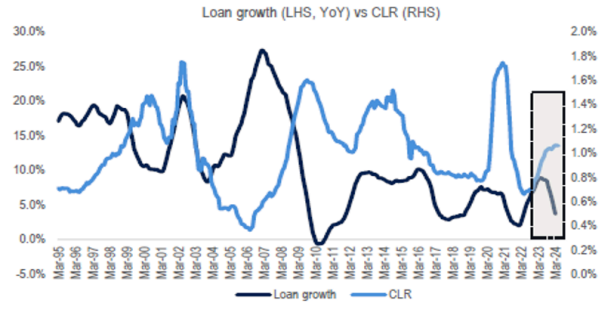
It has been over 170 days since the last instance of load shedding, indicating that Eskom operations are becoming more stable and consistent. Preliminary estimates suggest that loadshedding reduced South Africa's growth potential by as much as 1.2% of GDP per annum. Unlocking this growth constraint will not only foster more consumption activity for retailers, thus propping up their operating revenue line, but the alternative/diesel energy costs are also set to be reduced, removing as much as R1bn from the cost base for groups like Shoprite. This bodes well for the operating profit margins of these groups and allows some of these retail chains to invest in price, potentially easing affordability constraints for many consumers.

Unlocking consumer spending through energy and retirement reforms

The positive political and energy availability shift, combined with the introduction of the two-pot retirement system, which balances immediate financial needs with long-term savings, is expected to boost local businesses and consumer spending further. As much as R100bn is anticipated to be withdrawn in the two-pot retirement process, with much of these flows expected to be used by consumers to pay down debt, sustain daily consumption needs, and other entertainment expenditures.

Banking sector recovery and lending prospects

The post-COVID period and the accompanying interest-hiking cycle since December 2021 have seen a significant consumer affordability strain, which has left many unable to meet their debt-servicing obligations. This resulted in banks absorbing higher levels of cost of risk or impairments on the loans they dispensed, which restrained overall profit growth and reduced banks' appetite to accept new loans as they tightened their lending standards.



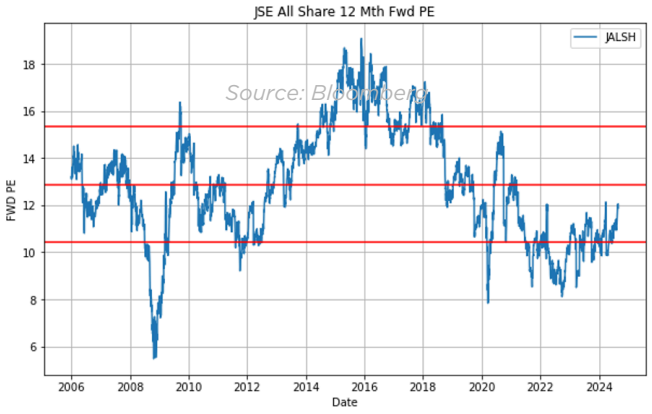
Source: SARB.

Credit loss ratios (CLR) across the banking sector, except for a few product sets, have peaked. The implication is better customer affordability, allowing banks to relax lending standards and grow their balance sheets. In an economic environment where GDP growth is sustainably above 2% and cost of risk and CLRs are peaking, banks have the opportunity to grow their revenue bases at lower impairment costs and potentially achieve earnings growth rates in the mid to high teens, an outcome last seen in the period 2010-2014.

"The two-pot retirement system is expected to release up to R100bn, boosting consumer spending."

Interest rate cuts and market implications

Finally, the anticipated interest rate cuts in September by the Federal Reserve and subsequently by the South Africa Reserve Bank will further stimulate economic activity by reducing borrowing costs, enabling business expansion, and increasing disposable income for consumers.



These interest rate cuts will likely further support risk assets from an equity market perspective. The recent rally in equity markets has translated into a mild rerating in earnings multiples. Should the South Africa reforms materially deliver on their objectives and corporate earnings respond, equity markets would have scope for a further rerating towards trend multiples.

Strategic portfolio positioning in an evolving economic landscape

Although we retain a core allocation of our portfolios in growth and quality stocks like Shoprite and Bidcorp, the improving macroeconomic fundamentals require that we also have a tilt in value stocks such as resources companies. Sentio's view is that a portfolio with more of a balance in styles is appropriate for the economic regime that the globe and our country are heading into.

We currently have a significant overweight to equities in our portfolios. From an equity market sector perspective, we prefer to be overweight in banks, resources, and select retailers. These overweight positions are funded by underweights in some Rand hedges like British American Tobacco, Richemont, and Property.

ABOUT THE AUTHOR

Olwethu Notshe joined Sentio as a Portfolio Manager in 2011.

Prior to this, he gained experience in financial markets at Coronation Fund Managers and Jacques Malan Consultants and Actuaries. He is an aviation enthusiast and licensed to fly a Sling II and Cessna 172 aircraft.

Olwethu holds a B.Bus Sci (Hons, Finance and Accounting) and is a CFA, CAIA and CQF charter holder.

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