

Sailing close to the wind

Izak Odendaal, Investment Strategist at Old Mutual Wealth

South Africa's Budget 3.0 was tabled in Parliament on the same day President Ramaphosa met US President Trump in the White House. The US Congress was also in the process of passing a budget – perfect timing to compare the fiscal policies of South Africa and the US.

Simply put, the two countries are moving in opposite directions. People with different political persuasions will disagree on which direction to take. Some will argue for tax cuts, others for higher taxes, especially on the super-rich. Many will argue for increased government spending, especially on social welfare, while others will prefer to reduce the size of the government. Viewed from the perspective of the market, however, it is clear. South Africa is trying to steady the ship, while for the US, it is a case of anchors away.

As for the meeting between Ramaphosa and Trump, expectations were quite low, and indeed there was a lot of bluster from the US president. The main thing is that a dialogue on trade has been opened, and this reduces the risk that US import tariffs on South African goods jumps to 30% again after the 90-day pause.

Uneventful

Compared to the fireworks of the first two proposed South African Budgets the third version was decidedly uneventful. However, in this context, boring is good, and the financial market response was muted.

The key thing from investors' point of view is that fiscal consolidation remains the priority. The debt and deficit ratios are similar to what was presented in March, though they are somewhat worse, mainly due to weaker expected nominal growth (i.e. a smaller denominator, not a larger numerator). Due to the abrupt change in US trade policies, global growth is expected to be lower and the domestic real economic growth outlook has been cut to 1.4% for 2025, 1.6% for 2026 and 1.8% for 2027. This is broadly in line with private sector estimates. Inflation is likely to be somewhat lower, reducing nominal growth. Weaker nominal growth tends to put downward pressure on tax collection.

As expected, there will be no VAT increase this year. However, unspecified tax hikes are pencilled in from next year (around R20 billion per year), suggesting a small VAT hike could still be on the table, but Treasury will be sure to get political buy-in beforehand. If SARS improves collection, this might not be necessary. As might be expected given the decline in global oil prices, the fuel levy will rise by 16 cents per litre. The basket of VAT zero-rated items will not be expanded, and there is no bracket creep relief for personal income taxpayers.

Without revenues from a VAT hike, some of the additional spending proposed in the first two attempted Budgets will be rolled back. Nonetheless, there is still a R180 billion increase to the baseline over the medium term, compared to R233 billion in Budget 2.0. This will support frontline delivery and infrastructure spending. Treasury plans to spend R1 trillion on infrastructure over the medium term. This a big number, but implementation remains the challenge. Spending reviews have identified around R38 billion in savings from closing down ineffective or unnecessary programmes. This will be applied to future budgets and could possibly mitigate the need for tax measures in 2026 and beyond.

Chart 1: South Africa's budget balance with projections

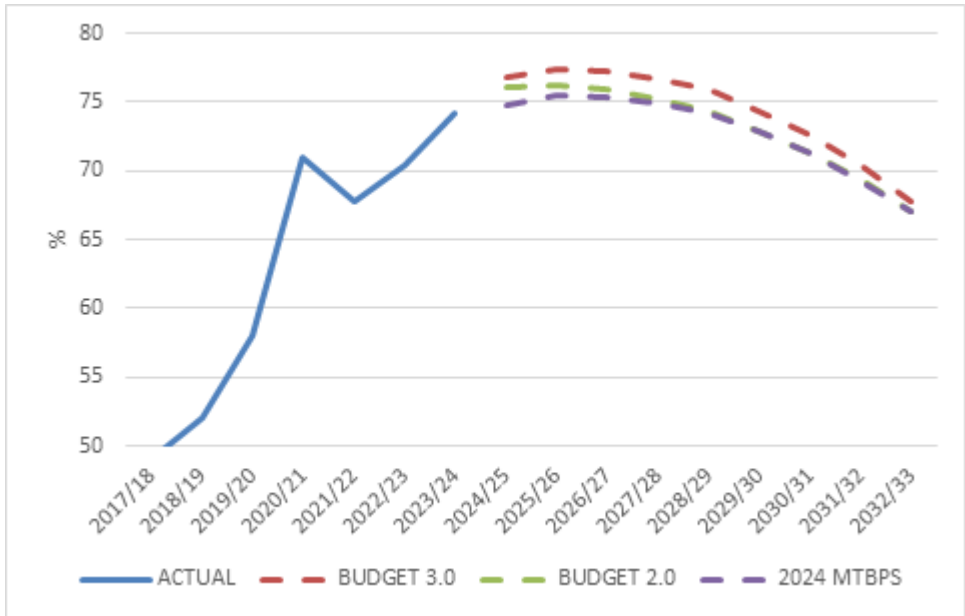


Source: National Treasury

Importantly, Treasury will maintain a primary surplus, meaning that tax revenue is projected to exceed non-interest spending. It will rise over the medium term from 0.7% of GDP to 2.1% in 2027/28. The main budget deficit, which includes interest payments, is expected to continue narrowing over the medium term, reaching 3.2% of GDP by 2027/28. In other words, the budget deficit now consists of interest payments.

As a result of running a primary surplus, the debt-to-GDP ratio is projected to peak in the current fiscal year at 77.4% and drift lower over time. A peak in the debt ratio has been promised for a decade, and never happened, but we are closer than ever.

Chart 2: South Africa's debt to GDP ratio with projections



Source: National Treasury

In a nutshell then, the third Budget for 2025 still represents broad policy continuity despite the various procedural disruptions. The country is still trying to rein in borrowing and stimulate economic growth. It is a difficult endeavour, and there are many risks ahead. However, evidence that this is happening will be positive for market valuations and lead to improved credit ratings.

We cannot say the same about the US, which was recently stripped by Moody's of its last AAA rating. The reason is not only that debt is rising relentlessly, but that there is no political will to turn the ship around. Instead, the ship is sailing full steam ahead into iceberg-infested waters. The US government was long assumed to be a stable, predictable and reliable custodian of the country's finances, and its bonds a safe harbour for global investors. One might add that the Titanic was also once thought to be unsinkable. Either way, the US does not lack the resources to manage its debt, it lacks the political will, and markets are starting to worry.

Big, but not beautiful

As the US Budget – theatrically dubbed The One Big Beautiful Bill – was approved by the House of Representatives, long-bond yields shot up in the US, which put pressure on other markets. The 30-year US bond yield breached the psychological 5% level, while Japan's equivalent broke through 3%, the highest in more than 20 years. Though South African yields are much higher, they've moved in the opposite direction over the past few weeks.

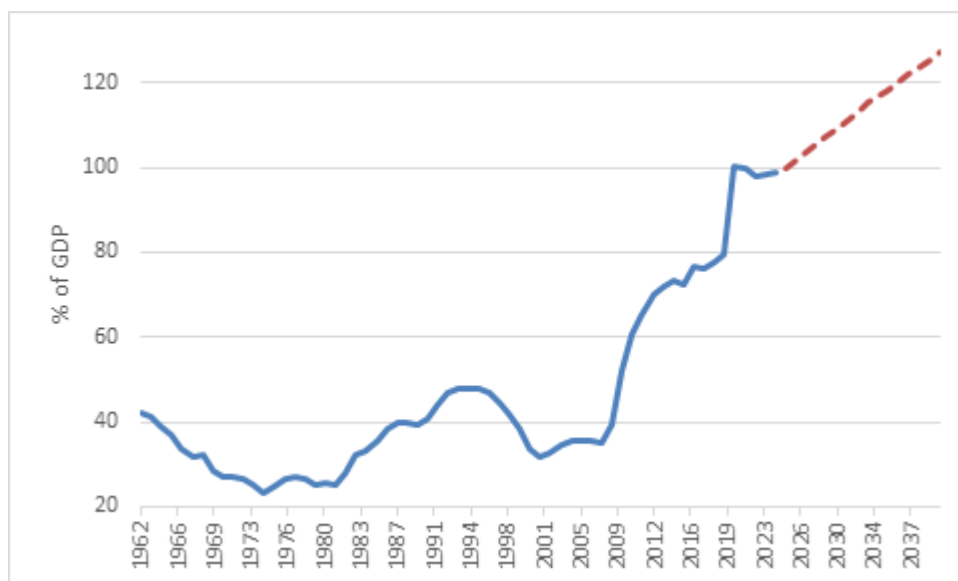
Chart 3: 30-year government bond yields, %



Source: LSEG Datastream

The US government debt ratio is projected to reach around 120% of GDP ten years from now. Twenty years ago, it was below 40%. The bill passed by the House will add an estimated \$3 trillion to US government debt over the next decade, but extending tax cuts from Trump's first term and adding new ones. There are some spending cuts, mostly on social welfare payments, and there will be additional income from tariffs, but not nearly enough to offset lower tax revenue. It must now be approved by the Senate, and might be amended, but the broad thrust of fiscal policy is clear: the US government will continue to borrow staggering amounts of money.

Chart 4: US debt-to-GDP ratio with projections



Source: Congressional Budget Office

The rapid increase in debt came mainly in the wake of two crises: the Global Financial Crisis in 2008 and 2009, and Covid in 2020. It makes sense for government debt to rise during deep recessions. The government is the spender of last resort as the private sector contracts, while tax revenues fall during a slump. However, when the economy recovers, government borrowing should be pared back, if only to create fiscal space for the next crisis. This did not happen in the US, and since the pandemic, it has been running deficits around 6% of GDP, levels usually only seen during recessions, even though the economy was doing very well, thanks in part to the fiscal stimulus.

Tax aversion

As the population ages, government spending on health and social security will inevitably rise. However, the bigger problem is arguably with revenue. America's tax-to-GDP ratio is one of the lowest among developed countries. The aversion to paying tax runs deep, particularly among Republican voters. Hence the current plans to reduce the tax burden even further, especially for the affluent. The tariff hikes are of course a form of tax, but will not offset cuts elsewhere, such that the deficit will rise further. Even worse is the deliberate hobbling of the Internal Revenue Service, through cuts to its budget and staff component. This is deeply counterproductive, since an effective, well-resourced tax collection agency pays for itself many times over. The opposite is happening in South Africa, and last week's Budget allocated an additional R4 billion to SARS to strengthen its capacity. The better SARS is at enforcing current tax laws, the less likely the introduction of new taxes are.

Governments don't have to pay down debt, since they are institutions with infinite lifespans, unlike households or corporations. However, governments must be able to service the debt (make interest payments) and be able to replace ("roll over") maturing bonds. For the US federal government, the debt service burden is where South Africa was in 2020, and is projected to be where South Africa is today 10 years from now, spending around 20% of revenue on interest payments by 2035. It already spends

nearly \$1 trillion a year in interest payments, and enormous amount, but not enough to sharpen politicians' minds.

Needless to say, the cost of borrowing matters. The higher government bond yields are, the quicker the debt service burden rises. For South Africa, this is a particular weak point, since yields hover around double digits. The US government borrowed cheaply in the low interest environment of the 2008 to 2022 period, but all this debt must now be replaced at much higher bond yields as it matures, in addition to the new borrowing.

It can become a vicious cycle, as South Africa experience over the past decade. Higher bond yields lead to slower economic growth, which worsens tax collection. This leads to more borrowing, which in turn makes investors more nervous. The fiscal risk premium on bonds rise, pushing yields even higher. Only a clear and credible commitment to fiscal discipline can break this cycle, as South Africa is now trying to do. It is not easy or painless and doesn't happen overnight. Once broken, trust repairs slowly.

While the fiscal deficits are positive for US equity earnings, higher US bond yields could put place pressure on equity valuations that are already quite rich in the US. Higher bond yields would also ordinarily lead to a stronger dollar, by attracting yield-seeking capital. However, we could see the opposite: a flight out of the dollar, which is quite strong by historic standards. Put differently, if we see both a weaker dollar and a weaker bond market, it is a clear sign that investors are worried about the fiscal situation.

It must be stressed that none of this will happen on predictable timelines. We are sailing into uncharted waters here, both in terms of the level of US debt and the fickleness of its politics.

Sense of crisis

Politicians hate trade-offs. Rearranging the deckchairs is always preferable to making tough choices. Or as former UK Prime Minister Boris Johnson once memorably confessed, "My policy on cake is pro having it and pro eating it."

It usually takes a sense of crisis for politicians to make difficult decisions, usually because they can see trouble in the markets, the streets or at the voting booth. In South Africa's case, that sense of crisis occurred in recent years. The poor state of the economy has forced a profound shift in thinking, and the private sector is being allowed – and encouraged – to invest in infrastructure. The ballooning interest burden makes the cost of fiscal laxity very real. Every rand that is spent on interest could have been spent on health, education or policing (or if you want to be cynical, on vanity projects or patronage politics). Unlike in the US, South African policymakers are trying to turn things around, though it will be a choppy process. Unfortunately, the American's failure to change course will have implications for the rest of us.

For investors, on the contrary, a sense of crisis can lead to detrimental behaviour. Investors are not well served by panicked decision-making. Things are likely to be particularly choppy and uncertain as long as Trump occupies the White House (as evidenced by his latest threat of tariffs on European imports). The best strategy is to be diversified and stay calm.