

More political drama

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Out of nowhere, a dense fog has crept over South Africa's political landscape. Not long after the 10-party government of national unity (GNU) reached the milestone of its first anniversary, its future looks shaky. President Ramaphosa unexpectedly fired Andrew Whitfield, a DA deputy minister, for the seemingly minor transgression of not getting approval to travel overseas in February. This is unlikely to be the real reason, and it caused much unhappiness on the part of the DA. Although the party indicated that it would not leave the GNU as it is not in the best interest of South Africa, it will pull out of Ramaphosa's planned National Dialogue. More importantly, the relationship between the ANC and the DA, the two largest members of the governing coalition, took another knock. The question of whether it will be a fatal blow is too soon to answer.

South Africa is far from the only country experiencing political turmoil from time to time, and it comes in different forms. At the extreme, there is violence on the streets as in Kenya in the past few days. Sometimes we see inconclusive elections and minority governments, where the largest party holds less than 50% of the seats in parliament, and hasn't cobbled together a coalition. Minority governments must manage by getting votes from opposition parties on an issue by issue basis. Canada, France and Japan are current examples. And then there is the US, where long-established political norms are being upended by the day. However, the US is coming off a long period of strong growth and wealth creation. It can "afford" some political dysfunction and has much credibility to lose. South Africa does not. It is trying to escape years of economic stagnation and has to gain investor trust and cut government debt at the same time.

The GNU is a platform to do so, and for this reason its formation was cheered by the market. By including the two largest parties in parliament, the ANC and DA, the GNU is more stable than alternative coalition scenarios that can be undone by small single-seat parties – as we've seen at municipal level. The other benefit is that while the two largest parties disagree on much, there is an agreement on core issues such as respect for the constitution and broadly centrist economic policies. They are natural bedfellows from an ideas point of view, but clearly not when it comes to personalities or political style.

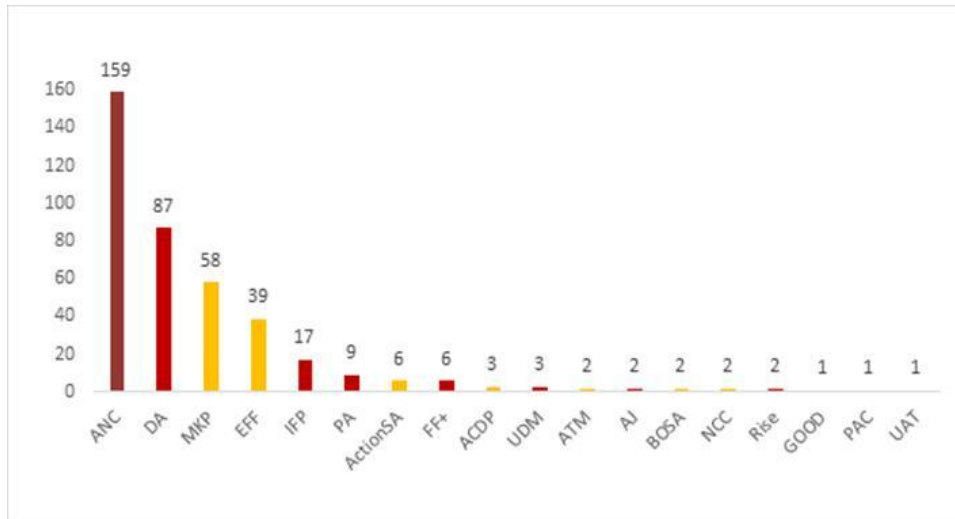
Opinion polls suggest that it is popular among the South African public too. This means that GNU members still have a strong incentive to hold their noses and continue to work together. However, with local government elections looming, each party must also present an independent identity to current and prospective voters. That's the difficulty with coalitions. If it operates too smoothly, voters don't necessarily know who to credit. Why not just merge the parties, they may ask. A degree of tension and competition is healthy in coalitions and parties can be expected to perform loudly for their constituencies. Too loudly, however, and with too much competition and tension, and relationships will fray to breaking point. South African politicians, voters and investors must all still get used to the nuances of coalition politics. And while it might lead to a weaker executive branch (a divided Cabinet), it can lead to a stronger legislative branch. Since no single party controls Parliament, there is more opportunity to hold the government accountable.

Before anyone makes hasty portfolio investments, here are five further points to remember.

Coalition scenarios

Firstly, the scenario that investors feared most before the 2024 election, namely that either the EFF or MKP would join the ANC in a coalition, still seems unlikely. Even if the DA was to pull out of the GNU, the remaining parties would have 50% of the seats in the National Assembly and can therefore survive a motion of no confidence.

Chart 1: Allocation of the 400 seats in the National Assembly

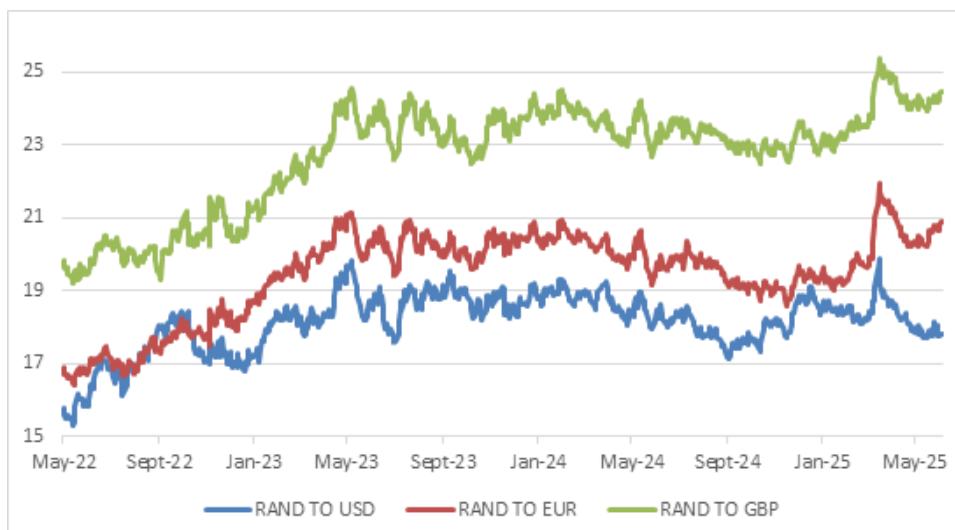


Source: Parliamentary Monitoring Group, GNU members in red

Secondly, South Africa is a small boat adrift on a big ocean. We obsess over local politics – not without reason – but often miss the global picture. It might be surprising that the rand reacted so little to the news. However, the US dollar has been on the backfoot, and this has prevented the rand from falling much. The trade-weighted US dollar index has fallen 10% this year.

The rand lost ground against the pound and the euro in the wake of Whitfield’s firing and is weaker year-to-date against both. The dollar matters more for investments, but the European currencies are important for trade and tourism. The dollar also matters more for interest rates, since our main import, oil, is priced in dollars.

Chart 2: Rand versus major currencies



Source: LSEG Datastream

Simply put, South Africa can still get lucky, but luck is not a strategy. It needs to get its house in order to truly benefit when the global environment is favourable, and to shield it when it is not. This brings us to the third point.

Evidence of progress

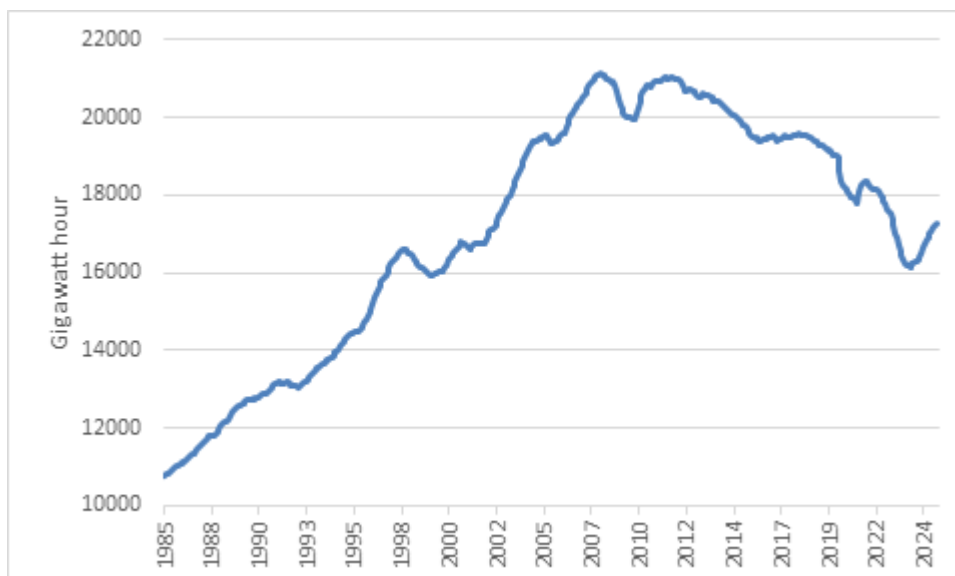
In terms of economic reforms, there is evidence of progress, notably the work of Operation Vulindlela (OV) which has unanimous support among GNU members. Rail and electricity are the economy’s biggest infrastructure bottlenecks.

In terms of rail, transport minister Barbara Creecy noted last week that her department received overwhelming interest to access Transnet’s rail network from private sector operators. Though it will take time to finalise and implement such arrangements, we are closer to the day that privately-run freight trains become commonplace. This is crucial, since South Africa is a big country, far from its export markets, and lacking any navigable internal rivers. It absolutely needs world-class rail and ports, something the state-owned monopoly could not deliver. Transnet will now evolve into mostly being a state-owned infrastructure provider (i.e. the tracks), with much of the daily operations (running the trains) done by the private sector. Breaking up the century-old monopoly and encouraging private sector involvement, represents a big mindset shift inside the ANC that predates the GNU. It can therefore outlast the GNU.

This change in mindset was first seen in the electricity sector, and as a result of the severe crisis of Stage 6 loadshedding. Ideally, politicians would always do the right thing, but in reality, they respond to external pressure, and it is usually only a crisis that they let go of deeply held but outdated ideas. The sudden shift towards increased defence spending in Europe, particularly in Germany, is a case in point.

South Africa’s poor economic performance over the past 12 years (it still managed 3% growth in 2013, believe it or not) has several causes but the lack of reliable electricity supply is number one. Eskom’s output started a precipitous decline from around 2012.

Chart 3: Eskom’s electricity production



Source: Stats SA

It is often said that economic activity is simply energy transformed. This is true, from the harnessing of steam power that gave rise to the first Industrial Revolution to the electricity-hungry data centres that power artificial intelligence.

Without reliable and affordable electricity, the country's economy has been hobbled. Companies became more energy-efficient, but this only works up to a point. The end of persistent loadshedding is therefore a massive development. It is partly due to better performance at Eskom, and partly due to private investment in electricity generation by households and businesses.

However, we are still in the early stages of a revolution of the country's electricity market. There are several elements of this. One is the national government's public-private renewable energy programmes, known as the Renewable Energy Independent Power Producer Procurement Programme (REIPPPP). The 5000 MW seventh bid window is currently in finalisation stage after preferred bidders were announced in December last year. Alongside this, preferred bidders for the third battery storage bid window were announced in May. It is officially known as the Battery Energy Storage Independent Power Producer Procurement Programme or BESIPPPP. What South Africa lacks in electricity, it makes up for in acronyms.

Separately, there is a massive pipeline of large-scale private investments in electricity, some 22 GW in total according to a recent OV estimate. Some of these projects are earmarked for specific customers, including Sasol, Anglo American, and other mining and industrial users, but others will sell into the emerging wholesale electricity market. It is envisaged that South Africa will have a completely competitive market by 2031, as is the case in most developed countries.

There is also the crucial element of building out the national electricity grid. Eskom's unbundling has spun out the National Transmission Company (NTCSA) as a standalone entity to act as the system operator of the wholesale market, but it must also increase transmission capacity, particularly from the solar-rich Northern Cape and the windy Eastern Cape. An estimated 14 000 km of new lines is needed. Most of this will be managed and funded by the private sector, effectively being toll-roads for electrons. A request for proposals will be put out later this year.

These are big reforms and there will be obstacles along the way. Most of the changes in the electricity sector have been legislated, meaning that they cannot simply be undone by a change in minister. In this vein, the transport minister noted last week that she is preparing a National Rail Bill to similarly cement the reforms in the logistics sector into legislation. The Economic Regulation of Transport Act has already been signed into law, governing third party access to Transnet rails and allowing for a single regulator across road, rail, shipping, ports and aviation.

Institutional strength

The fourth factor to remember is the strength of the country's key institutions. Some are too weak, yes. It is never good news when the national head of Crime Intelligence is arrested. It highlights that there is rot in the police, and it is no surprise that organised crime has flourished. But the fact that the arrest was made by the new Investigating Directorate Against Corruption indicates that it is not all doom and gloom.

For the investor community in particular, there two key institutions, namely Treasury and the Reserve Bank. Despite the Budget wobbles earlier this year, Treasury continues to do credible work and is steering the stabilisation of government debt despite it being politically challenging. It has also led the charge in getting South Africa removed from the Financial Action Task Force grey list, something that looks likely by year-end or early next year.

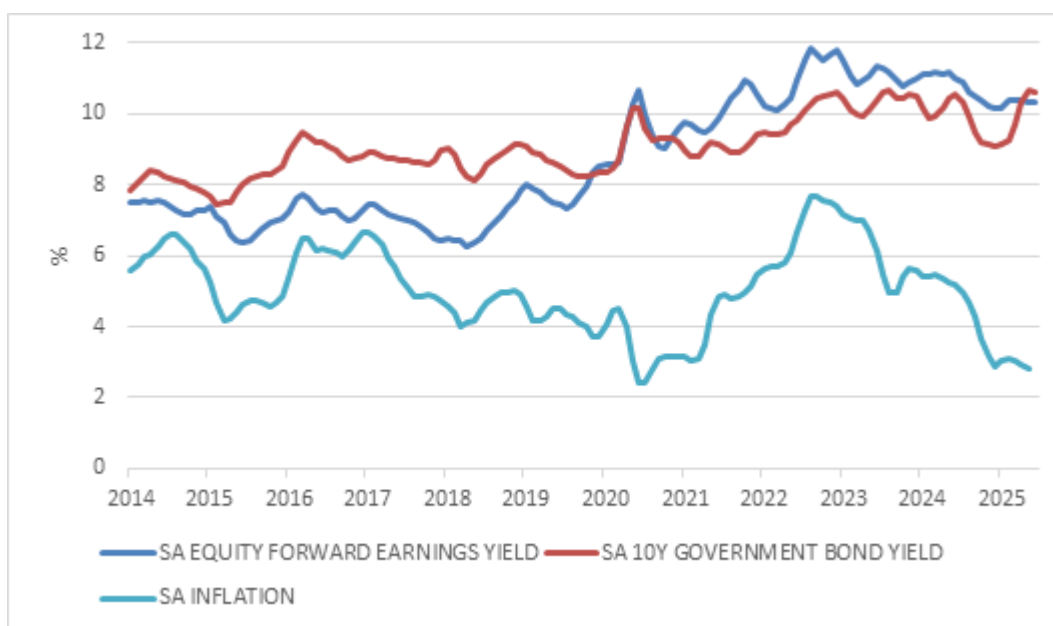
The Reserve Bank’s operational independence is guaranteed by the Constitution, and this is not always appreciated widely enough. In the US, President Trump has attacked the Federal Reserve’s independence and might announce the next Federal Reserve chair early to undermine the incumbent, Jerome Powell, whose term only expires in May next year. Trump has been pushing for lower interest rates – as politicians tend to do – but Powell’s Fed wants to be sure that the data supports rate cuts. If the Fed is ultimately strong-armed into lowering rates, it takes us back to the Nixon era, a time of a weak dollar and high inflation.

In contrast, the South African Reserve Bank wants a lower inflation target and is likely to succeed both in lowering the target and eventually anchoring inflation expectations around that target. This is a positive for longer-term financial assets, though is not a free lunch, implying somewhat higher interest rates in the shorter term compared to an unchanged inflation target.

Not giving up

Fifth and finally, local assets already have a notable margin of safety. The political uncertainty that has long plagued the country is already discounted into the market. Simply put, investors fear the risk of a populist government taking over at some point, abandoning fiscal discipline and following business-unfriendly policies. How likely you think this outcome is will determine how you view South African investments, but current valuations imply attractive real returns from local bonds and equities are achievable over the medium to longer term, even when applying conservative inflation and economic growth assumptions.

Chart 4: SA bond and equity yields



Source: LSEG Datastream

In conclusion, despite increased political noise, we're not giving up on South Africa. However, this episode is a reminder of why appropriate global exposure makes sense. This is not just to hedge against political and economic risks in South Africa, but also because of the much greater opportunity set abroad. Most South African investors are probably overexposed to the local economy, once they take employment and residential property ownership into account. The key is to do things in a considered matter, and to avoid knee-jerk reactions to political news, whether it stems from the Union Buildings or the White House.