

Budget Preview – The most important budget in 26 years...

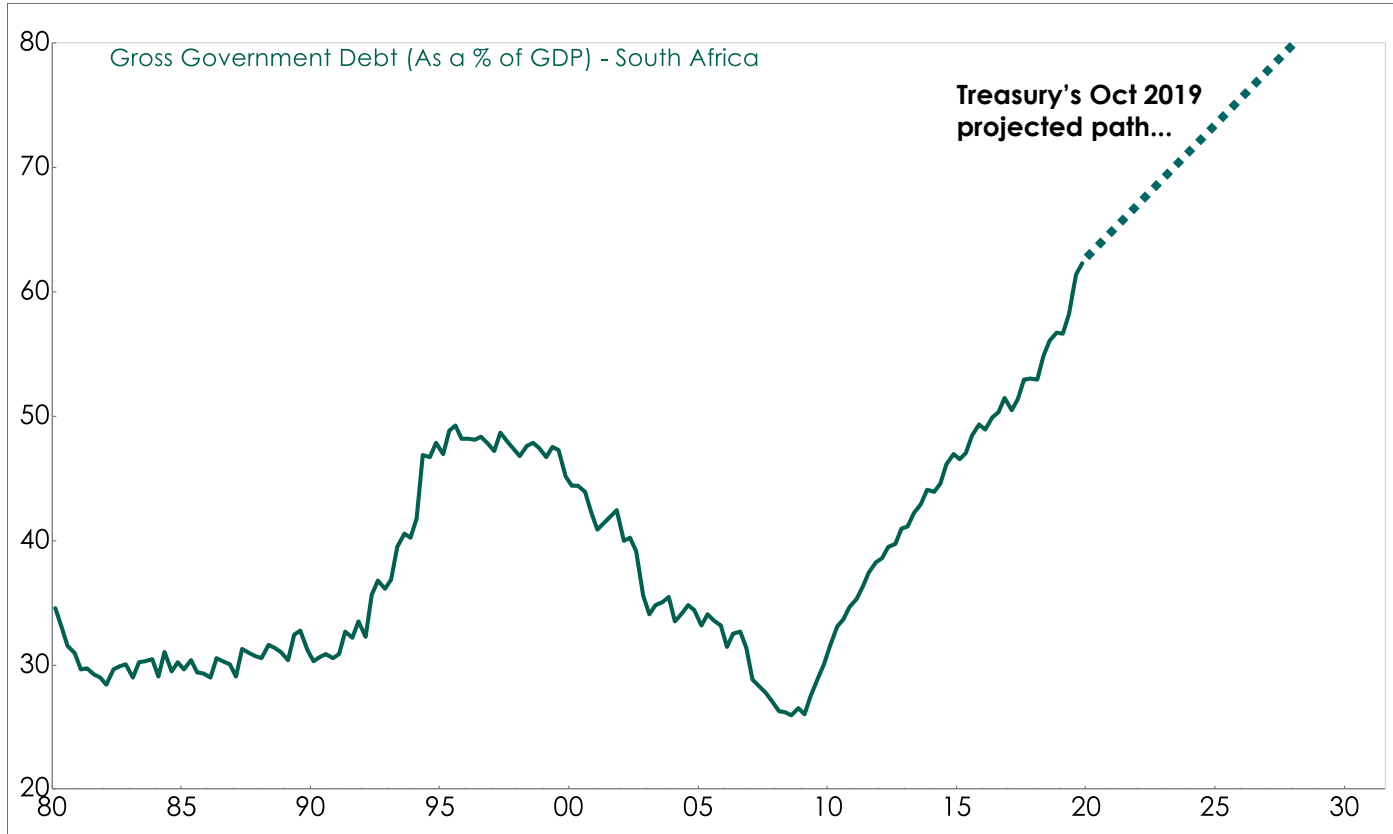
Unlikely to satisfy investors and Moody's...

20 February 2020
Johann Els





This is the issue: rising debt ratio in a no-growth environment with no serious spending cutbacks





Budget preview - summary

Serious action needed to overcome significant challenges. While some action is likely, it will not be enough to prevent ratings downgrade.

- Disastrous MTBPS last October
- Very weak economic growth
- Urgent need to reduce deficit ratio and stabilise debt ratio

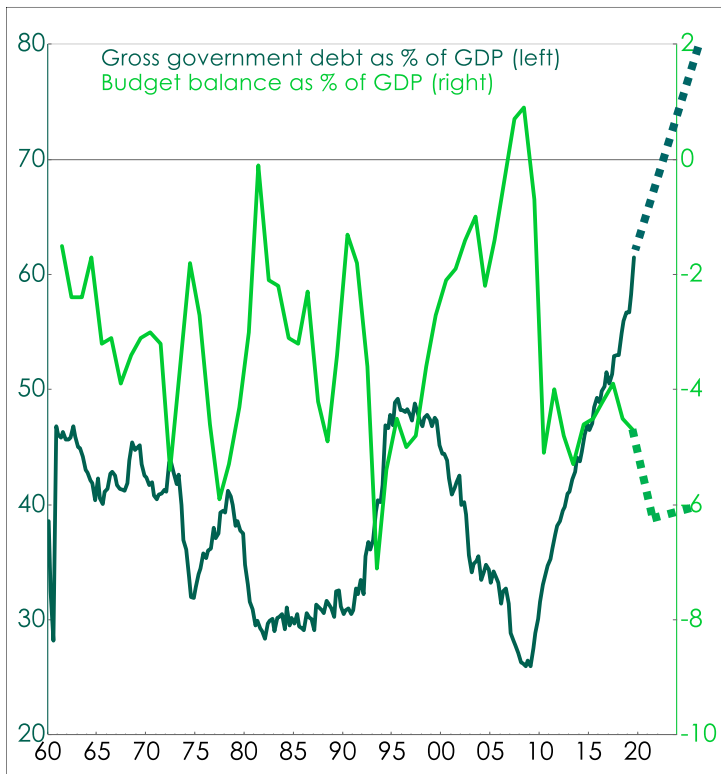
But, with real interest rates much higher than real growth, a large consolidation package is needed to stabilize debt ratio.

- Will Treasury be able to do enough to prevent a downgrade from Moody's?
- Very unlikely – I expect a downgrade to junk status – and thus exit from WGBI.
- Only issue is timing – dependent on Treasury's ability to convince Moody's of future fiscal path...



Sharply higher deficit and debt ratios

Due to weak growth and inability to get spending under control – deficit stuck around 4% after GFC and then back to 6%+ over the past year.



SOUTH AFRICAN AIRWAYS

A STAR ALLIANCE MEMBER



	Provisions & Contingent liabilities Rbn	Provisions & Contingent liabilities % GDP
2008/09	257	10.7
2019/20	1207	22.3

	Interest payments on debt, Rbn
2007/08	53

2019/20

202

This is more than the annual budgets for health, education and police services combined!

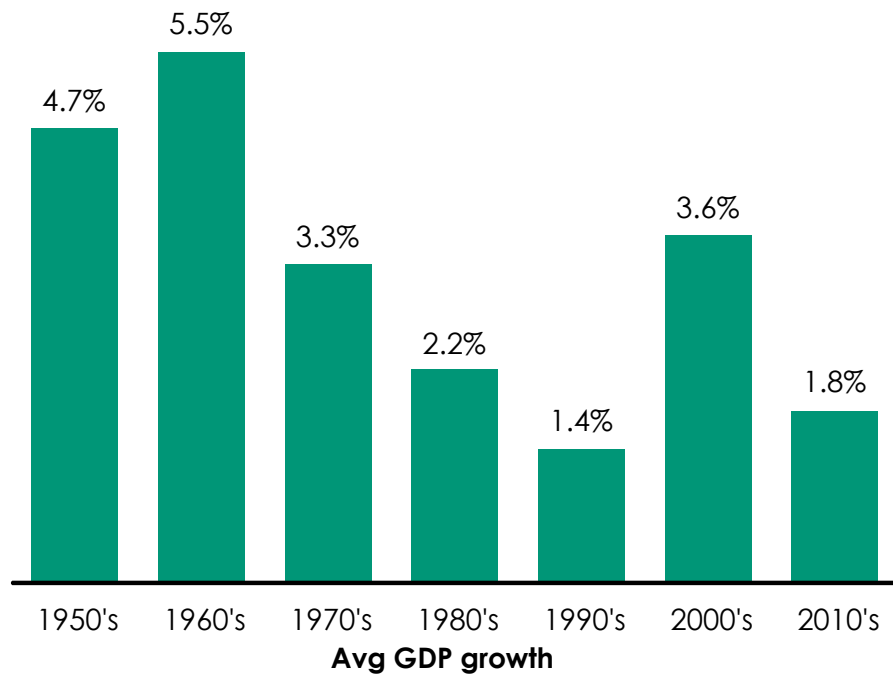
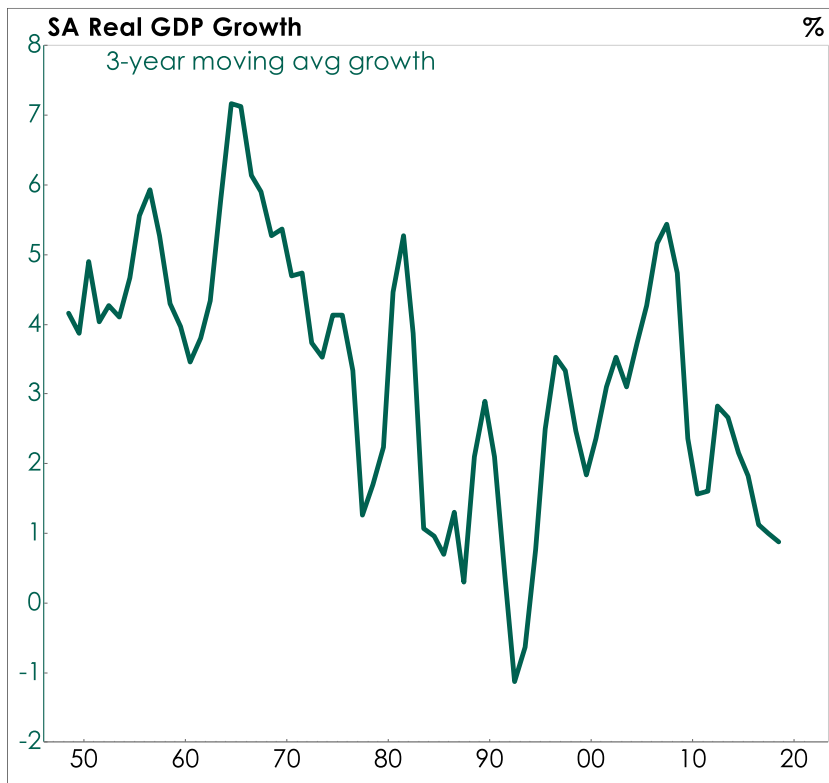


But first, the economy...



Dismal economic growth...

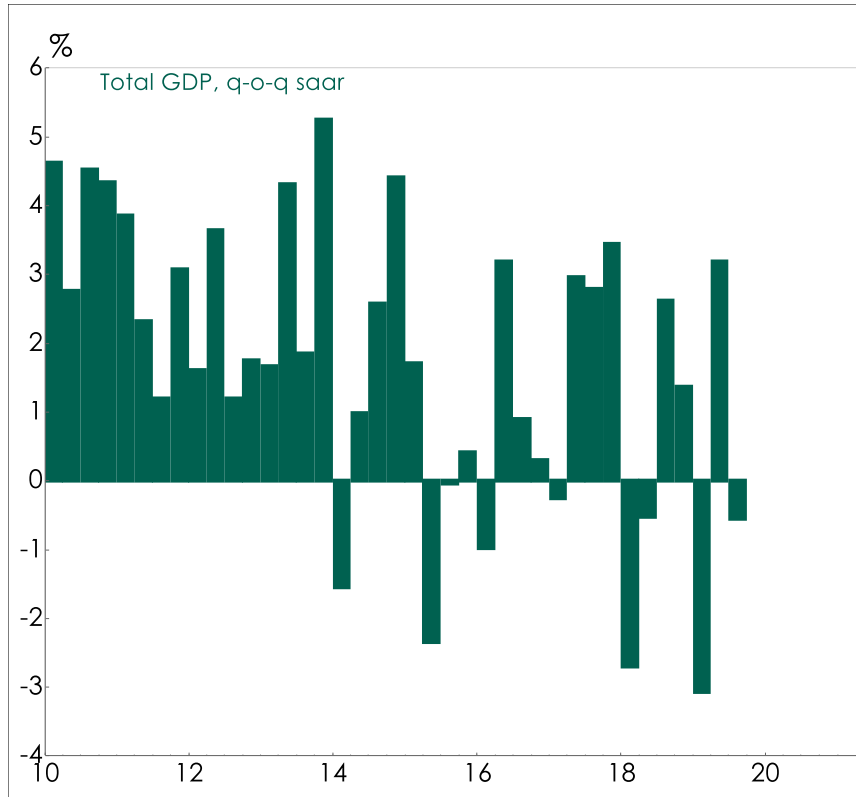
Significant downtrend since 1950's and 1960's – briefly interrupted by post new South Africa





Dismal economic growth...

Increasingly volatile quarterly growth performance; and very weak growth past 5 years



2000 - 2008
4.2%

2010 - 2018
1.8%

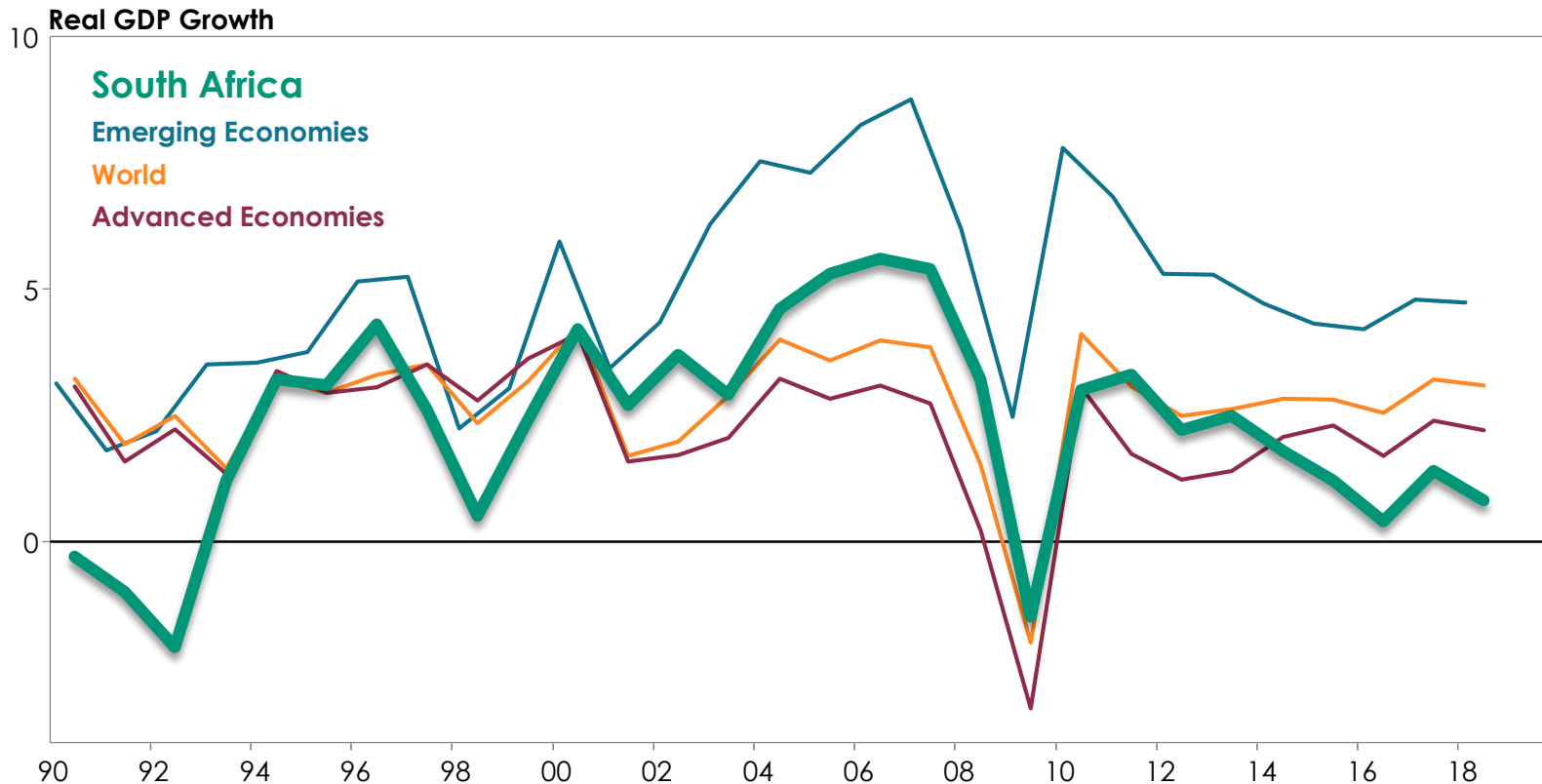
2004 - 2007
5.2%

2015 - 2019
1.0%



Underperforming relative to the world...

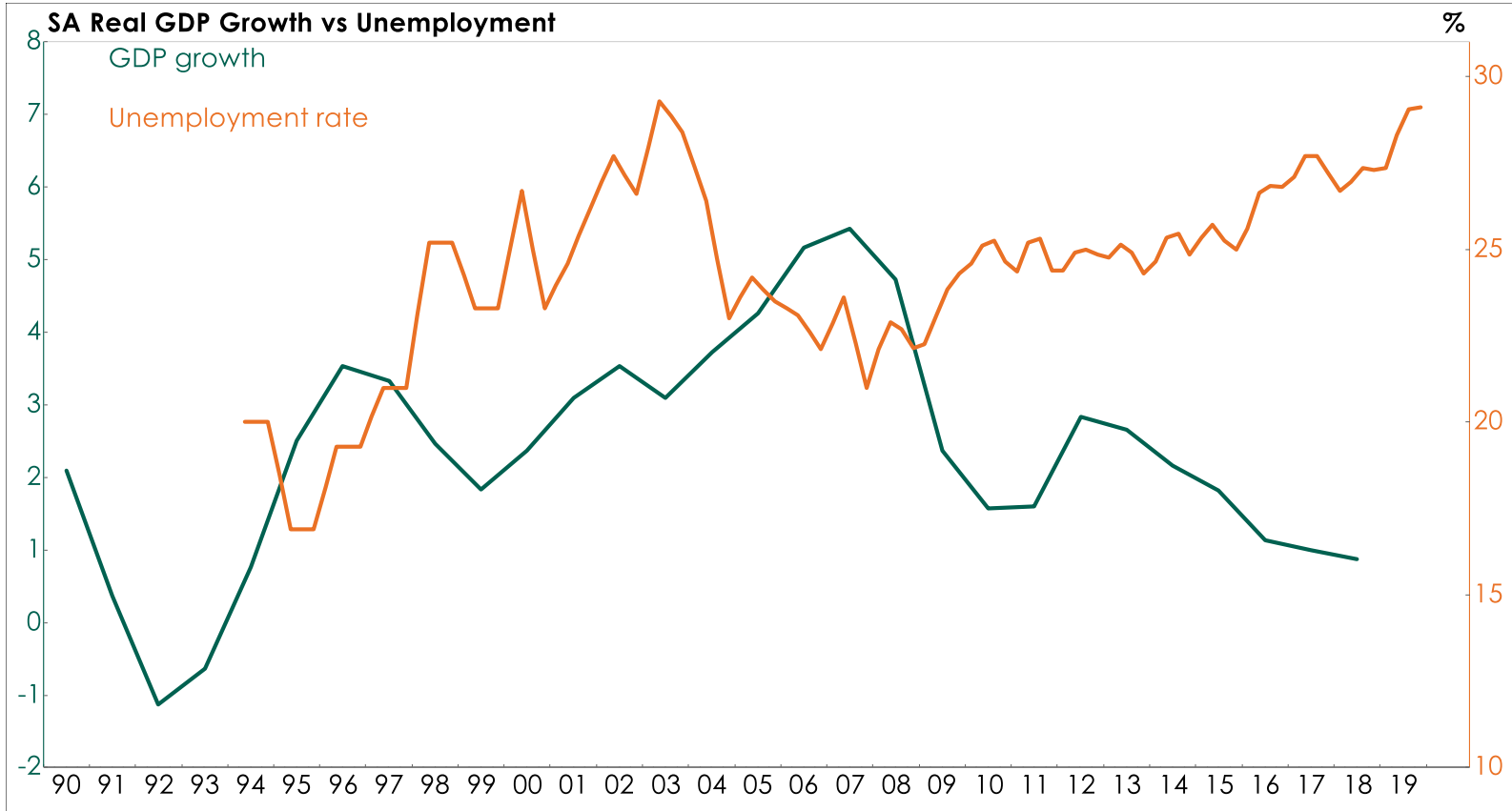
Compared to the rest of the world – whether developed or emerging...





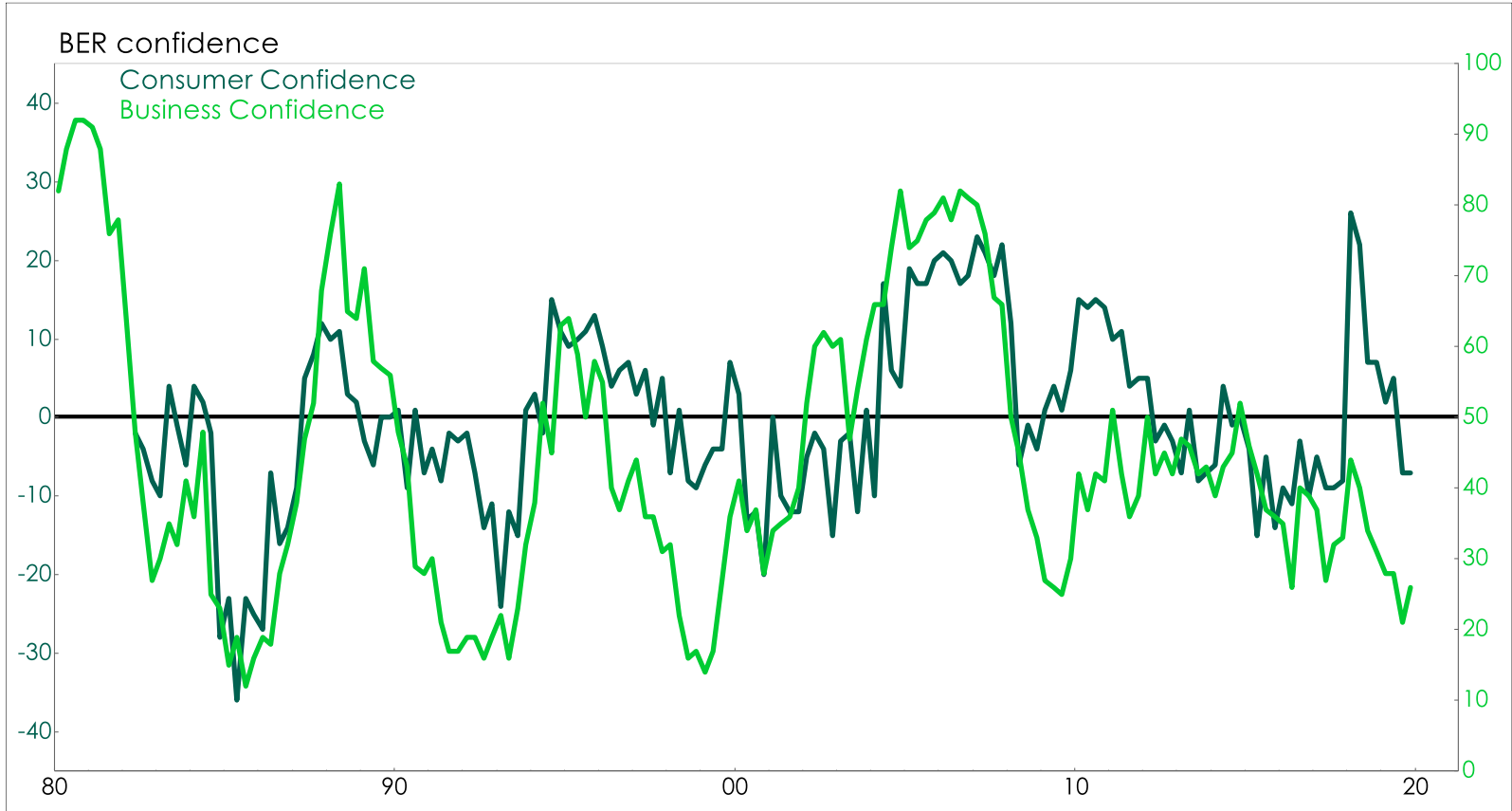
Unemployment bigger and bigger problem

But sustained higher growth could make a difference!





Disillusioned consumers & businesses



Source: Old Mutual Investment Group



Back to the upcoming budget...

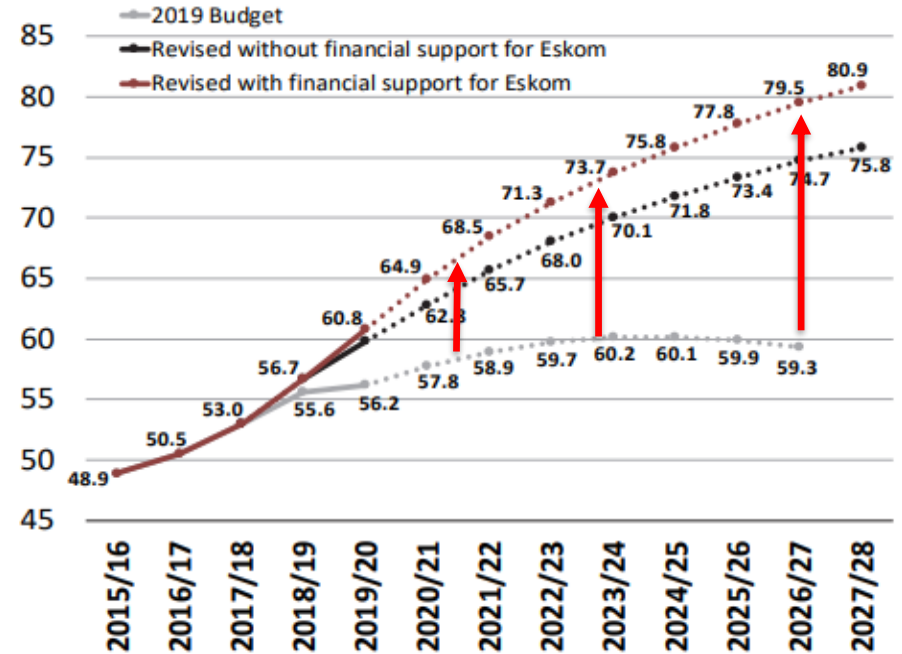


Budget preview – MTBPS sketched the worsening situation

Wider deficits, and deteriorating debt profile

	2019 /20	2020 /21	2021 /22	2022 /23
Budget deficit (Feb 2019 budget), % of GDP	-4.5	-4.3	-4.0	
Budget deficit as per Oct MTBPS , % of GDP	-5.9	-6.5	-6.2	-5.9

Debt as share of GDP





Ratings downgrade from Moody's likely – UNLESS February budget moves the dial **SUBSTANTIALLY**

Both Moody's and S&P moved outlook statement from stable to negative after MTBPS in October

South Africa	Moody's	S&P	Fitch
Investment grade	A3	A-	A-
	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	BBB-	BBB-
Sub Investment	Ba1	BB+	BB+
	Ba2	BB	BB
Outlook	Stable Negative	Stable Negative	Negative
OMIG expectations	More than 50% probability of ratings downgrade into sub-investment grade early 2020.	Rating likely on hold – for now. But increased risk of further downgrades deeper into sub-investment grade territory.	Rating likely on hold – for now. Waiting for update on view...

 Local currency rating
 Foreign currency rating

Moody's:

Messaging somewhat distorted...

- **After MTBPS** changed outlook to negative and issued warning that Feb budget needs to move the dial substantially to avoid a downgrade (implying that the "normal" 18 to 24 mth period post outlook change might not apply).
- **Earlier this year** changed that view somewhat, stating: It's "a bit early" to judge the government's policy and structural reforms after changing outlook negative almost three months ago
 - "It is relatively fresh, our negative outlook"
 - Next review date: 27 March - date is tentative and the company is not obliged to stick to it...
 - ... "The outlook is negative, so what we are flagging is not a necessarily immediate downgrade."
- **This week** in an update: did not mention fiscal policy at all, just focused on weak growth and tight monetary policy, implying rates could be lowered...



The latest data for the present fiscal year (up to Dec 2019)

Revenue below target and expenditure slightly above target (revised MTBPS targets)

2019/20 fiscal year (consolidated budget)

	Dec		April - Dec		MTBPS Target (Oct'19)	
	Rbn	y-o-y %	Rbn	y-o-y %	Rbn	%
Revenue	160.4	+2.3	967.0	+4.8	1 537.8	6.4
Expenditure	162.5	+14.2	1216.8	+12.0	1 844.1	11.6
Balance	-2.1		-249.8		-306.2	-5.9% of GDP



The latest data for the present fiscal year (up to Dec 2019)

Individual income tax and fuel levy ahead of targets, the others lag significantly...

Revenue: 2019/20 fiscal year (consolidated budget)

	Weight	Dec	April - Dec	MTBPS
	%	y-o-y % change	y-o-y % change	(Oct'19)
Ind income tax	39.4	+7.4	+7.9	7.2
Co's	16.4	-0.7	+2.4	3.3
VAT	25.7	+4.2	+1.9	7.3
Customs	4.3	-2.7	-0.7	6.2
Fuel Levy	5.9	+2.1	+5.3	4.0



Budget preview – what needs to be done vs what will be done?

Unlikely that enough will be done...

What needs to be done:

- At the very least, deliver on MTBPS fiscal consolidation plans
 - Achieve primary balance* (excl Eskom support) by 2022/23
 - Cut expenditure by R150bn over next three years
- But, to avoid downgrade, do more
 - Large expenditure cuts AND limit wage bill growth
 - Tax hikes also needed
 - Get deficit ratio back towards 4.5% in 3 year's time (vs MTBPS target of -5.9%)
 - Show credible path towards debt ratio stabilisation around 70% to 75%

What will likely be done:

- Some effort, but not enough:
 - some spending cuts; nothing on wage bill this year (maybe some promises for next year)
 - Some tax hikes
 - Deficit still around 6% to 5.5% in 3 year's time
 - Debt ratio still rising towards 80%, no stabilisation



In June 2019 Treasury instructed govt departments to cut budgeted spending over the next 3 years. Is this still on the cards?

Expenditure cuts will help...but difficult to achieve large cuts if wage bill, interest payments and social grants are excluded from the cuts.

	2019 /20	2020 /21	2021 /22	2022 /23
Budget deficit (Feb 2019 budget), % of GDP	-4.5	-4.3	-4.0	
Budget deficit as per Oct MTBPS, % of GDP	-5.9	-6.5	-6.2	-5.9
Total Expenditure (Oct 2019 MTBPS), Rbn		1978.7	2097.5	2214.9
Expenditure excluding wage bill, social protection & interest costs, Rbn		842.2	871.5	896.3
Expenditure cutbacks (as per treasury directive), Rbn		42.1	52.3	62.7
		Cumulative cuts of R157bn		
Reduced spending, Rbn		1936.6	2045.2	2152.2
Projected dadjusted budget deficit (after expenditure cutbacks), % of GDP		-5.8	-5.4	-4.9

What are the options to get the budget and debt under control?

- Print money (**very** unlikely)
 - Allow higher inflation (**very** unlikely)
 - Raise taxes (difficult in this environment)
 - Sell assets (unlikely on large scale, will take time)
 - Sell spectrum (small, will take time)
 - **Cut expenditure**
 - **Lift growth**
- **best options: cut expenditure** (quickest option) **and lift growth** (through structural policy adjustments).



Difficult to move the dial significantly on spending cuts without cutting wage bill costs...

i.e. limiting wage bill growth to 4% pa over the next 3 years could (ceteris paribus) bring deficit ratio down to 5.1% by 2022/23 vs the MTBPS target of 5.9%.

	19/20	20/21	21/22	22/23	
Wage Bill (as per MTBPS)					
Rbn	630.7	675.2	717.6	758.5	
% growth	7.9	7.1	6.3	5.7	
If wage bill growth limited to:					
then savings per year, Rbn					Cumulative savings, Rbn
6%		6.7	8.9	7.3	22.9
4%		19.3	35.4	49	103.7
2%		31.9	61.4	82.6	175.9
0%		44.5	86.9	127.8	259.2
If wage bill growth limited to:					
then deficit would be (ceteris paribus), % of GDP					
6%		-6.4	-6.0	-5.8	
4%		-6.2	-5.6	-5.1	
2%		-5.9	-5.2	-4.6	
0%		-5.7	-4.7	-3.9	
Vs MTBPS deficit targets, % of GDP	-5.9	-6.5	-6.2	-5.9	

Limiting growth in wage bill probably easier than job cuts or 0% wage increase

- This could lead to substantial savings
- And could lead to lower deficit fairly quickly
- i.e. Limiting growth to 4% pa could mean cumulative savings of R104bn
- And could mean a deficit of -5.1% (vs MTBPS target of -5.9%)
- Is this likely though?



Difficult to move the dial significantly on spending cuts without cutting wage bill costs...

Combination of some cuts in expenditure excluding interest, wage and social grants with some wage bill measures – could have a more meaningful impact on the deficit ratio...

	2019/20	2020/21	2021 /22	2022 /23
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Expenditure excluding wage bill, social protection & interest costs, Rbn		842.2	871.5	896.3
Expenditure cutbacks (3% across non-wage, interest & social grants <u>AND</u> containing wage bill growth to 4%), Rbn		44.6	61.5	75.8
		Cumulative cuts of R182bn		
Reduced spending, Rbn		1934.1	2036.0	2139.1
Adjusted budget deficit (after expenditure cutbacks), % of GDP		-5.7	-5.2	-4.7

Would an improved deficit profile like this (i.e. 4.7% deficit by 2022/23 vs MTBPS target of 5.9% deficit) **be enough to prevent a ratings downgrade by Moody's?**

Yes...

But, while some movement in the right direction is likely, Treasury will probably not do this much – thus not enough to prevent sub investment grade rating.

Moody's thus expected to downgrade SA into sub investment grade early in 2020.



Focus should be on expenditure cuts, but some revenue measures also expected...

A reminder of the options...

A levy on income tax could potentially be a trade-off for some kind of wage freeze in public sector...

Tax options: (and possible revenue) (in my order of likely implementation)

- Normal sin tax hikes (excise taxes) (R1bn – R2bn)
- No or limited relief for fiscal drag (i.e. bracket creep): R10 – R14bn
- Big fuel levy hike? (R5bn)
- CGT & dividend withholding tax increases? (A 3.5ppt increase in the capital gains tax rate = R2bn pa; dividend withholding tax = R8bn for 5ppt increase)
- Wealth tax?
- VAT hike (1.0% = R23bn) / luxury goods VAT?
- Temporary Income Tax surcharge (individuals and companies a la transition levy of 1994)? (R35bn to R40bn)
- Higher top marginal tax rate? (the 4ppt increase in 2017 on income above R1.5m per year yielded an estimated R4.4bn in additional revenues)

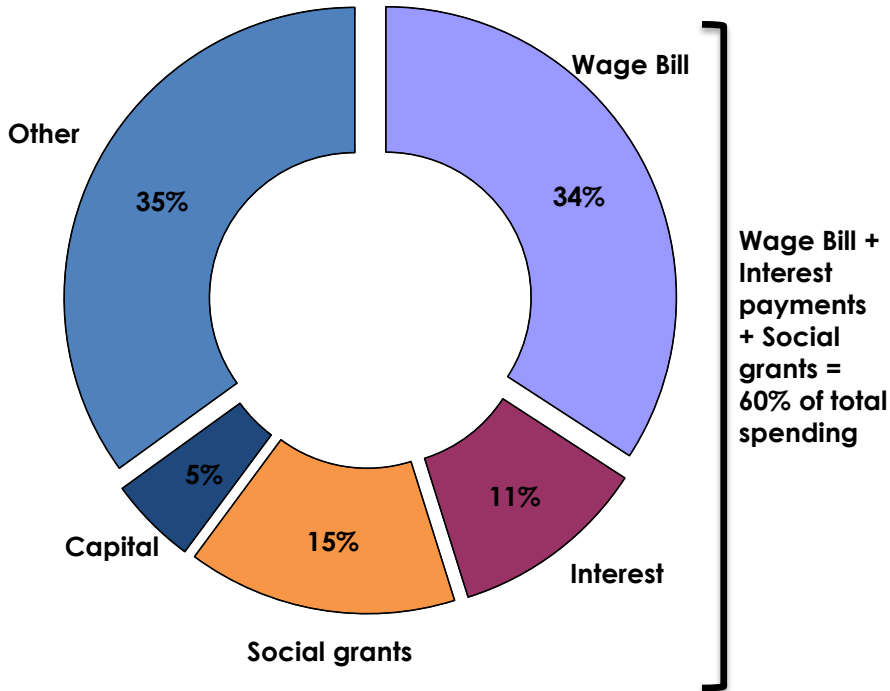
Some notes re possible income tax levy:

- 282.6k individuals in R1m+ pa tax bracket
- Earning taxable income of R557bn
- Paying income tax of R225.6bn
 - 4% of this = R9bn
- Transition levy of 1994/95 collected 3.5% of total Individual Income Tax and 8.5% of total Company Income Tax
- Similar share now would be R18bn & R19bn = R37bn

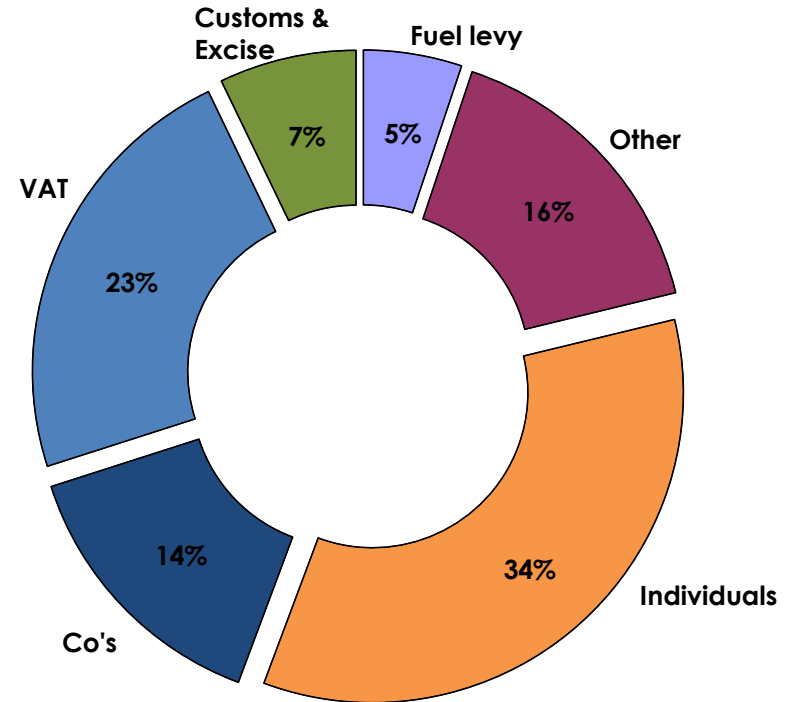


Main spending & revenue components

Main expenditure components (as % of total consolidated spending, 2019/2020)



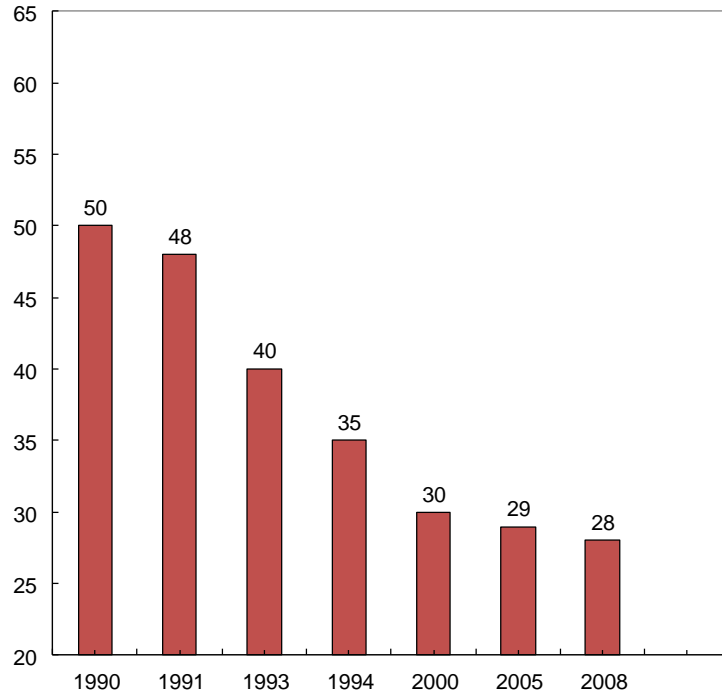
Main tax revenue components (as % of total revenue, 2019/2020)



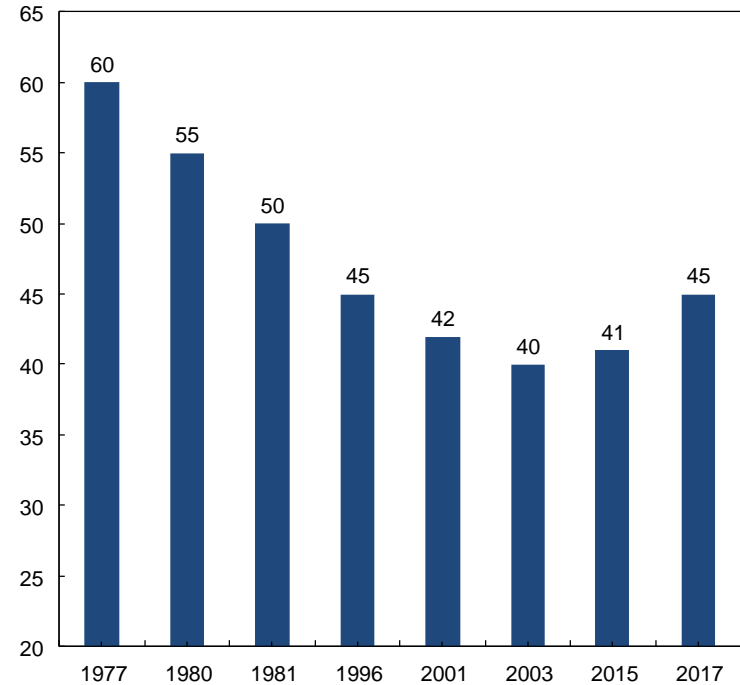


Income tax rates over the years

Company tax rate changes



Individual income tax rate changes (top marginal rate)





The 2019/2020 & 2020/21 fiscal years in numbers

Unlikely that the estimated move from -6.2% budget balance in the present fiscal year to -5.9% balance in the next fiscal year will be enough to satisfy investors or ratings agencies.

	2019/2020 fiscal year			Feb 2020 budget (2020/2021 fiscal year)				
Rbn	Feb-19	MTBPS (Oct 2019)	Johann's est of outcome	Treasury's Oct 2019 est	Johann's est (relative to Oct 2019 est)		What is the potential - but unlikely (relative to Oct 2019 est)	
Revenue	1583.8	1537.8	1527.8	1618.5	1638.5	R20bn tax hikes	1668.5	R50bn tax hikes
Expenditure	1826.6	1844.1	1844.1	1978.7	1958.7	R20bn exp cuts	1928.7	R50bn exp cuts
Budget balance (Rbn)	-242.8	-306.3	-316.3	-360.2	-320.2	Cumulative R40bn consolidation effort	-260.2	Cumulative R100bn consolidation effort
Budget balance (% of GDP)	-4.5	-5.9	-6.2	-6.5	-5.9		-4.8	
Nominal GDP	5413.8	5200	5100	5542	5390		5390	



FEBRUARY BUDGET – BOTTOM LINE

Effort unlikely to be enough to prevent ratings downgrade

- Attempt to rein in deficit and stabilize debt ratio likely through combined expenditure and revenue measures
- But – not enough will be done to satisfy Moody's
- Ratings downgrade to sub investment grade thus the base case
- This is mostly expected and thus priced
- => this will not derail economy, reform, or fiscal improvement



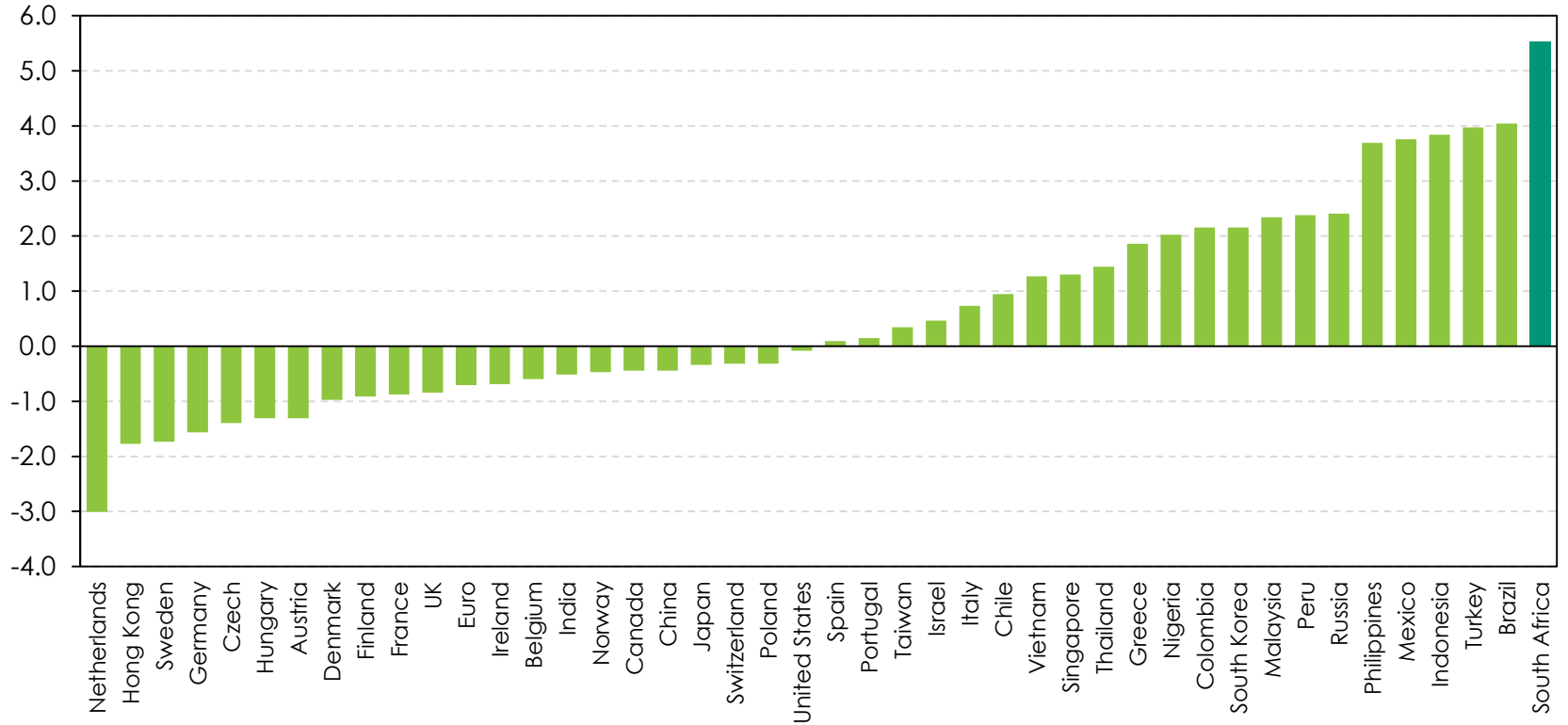
Moody's: downgrade imminent – priced in?

Seems priced in...

- Downgrade has been expected for a long time
- Bond yields and currency have had time to digest the news
- Negative news continued uninterrupted – latest loadshedding, growth and MTBPS
- Realisation that February budget unlikely to move the dial
- “Priced in” probably means little price action in bonds and currency of any lasting nature (some knee-jerk/short term reaction likely)
- Index outflows countered by active investment inflows
- RISKS:
 - Deteriorating world economy on back of coronavirus
 - No effort in Feb budget to correct deficit and debt profile → double downgrade → large net outflows → big currency and bond reaction
 - 2-notch downgrade would be a shock as it is not expected – but seems unlikely...
 - OR – what if we are all wrong – Moody's willing to accept a gradual path towards fiscal consolidation over the next few years? Unlikely...

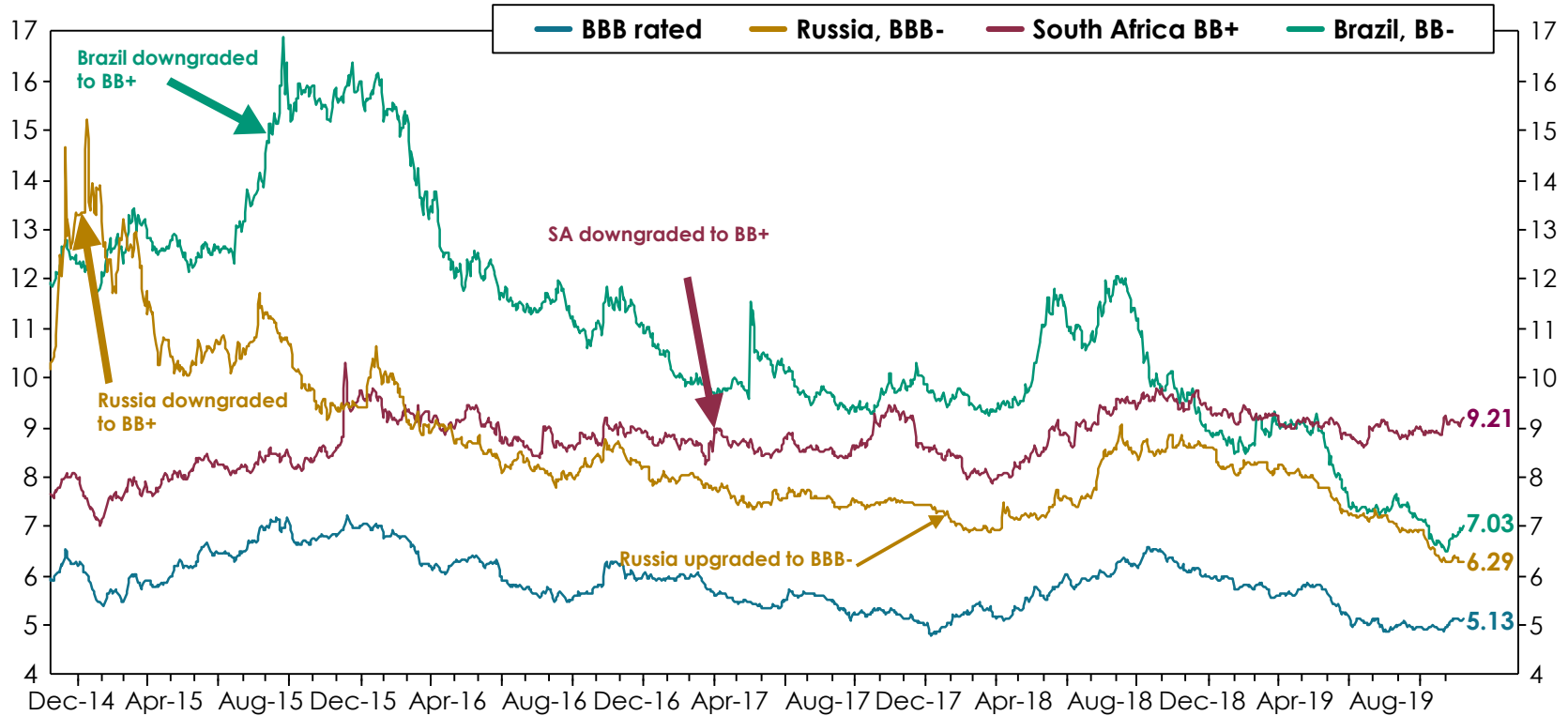


Real 10 year bond yields





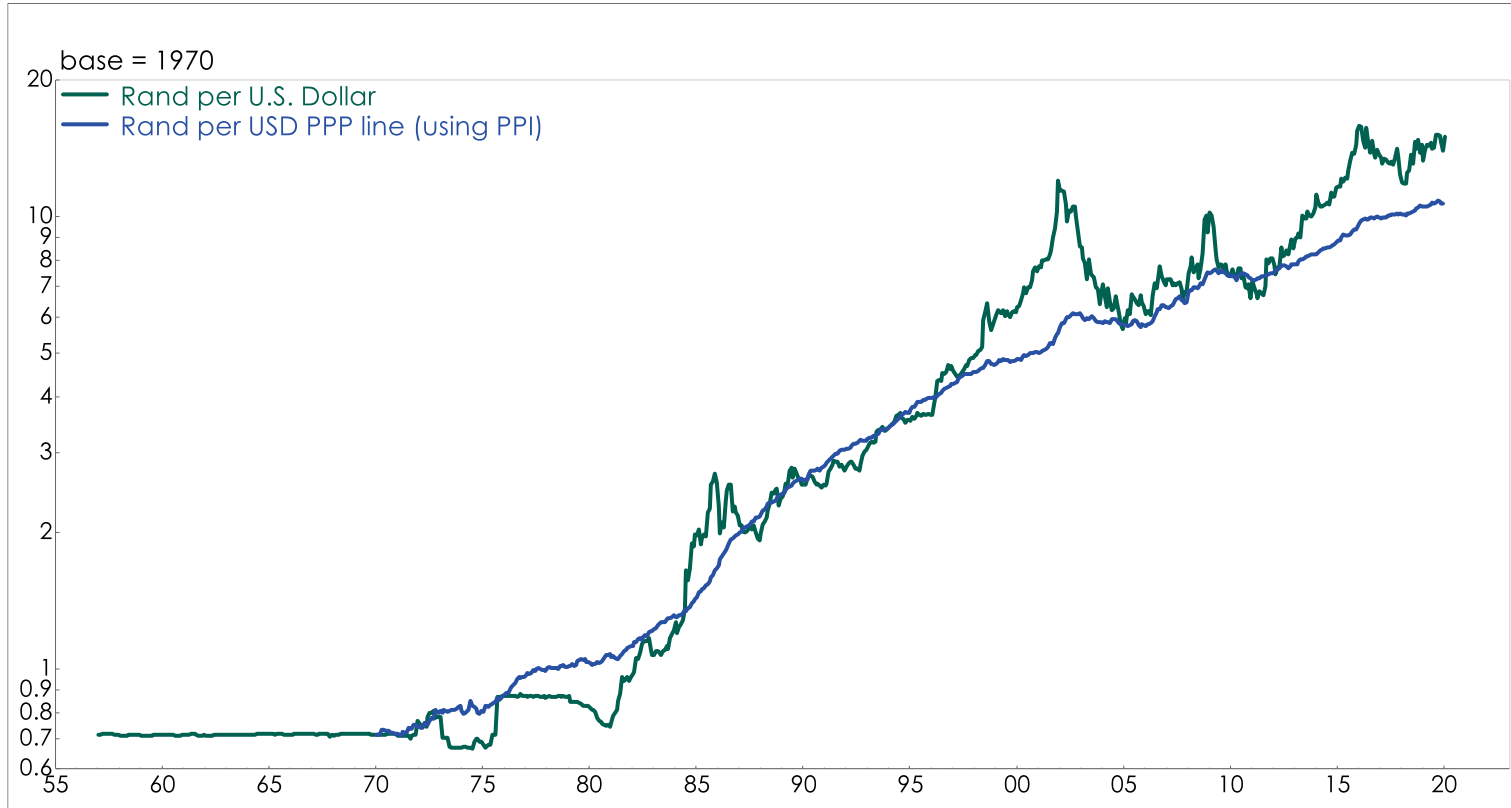
SA bonds price in further downgrades





RAND: NEGATIVES MOSTLY PRICED

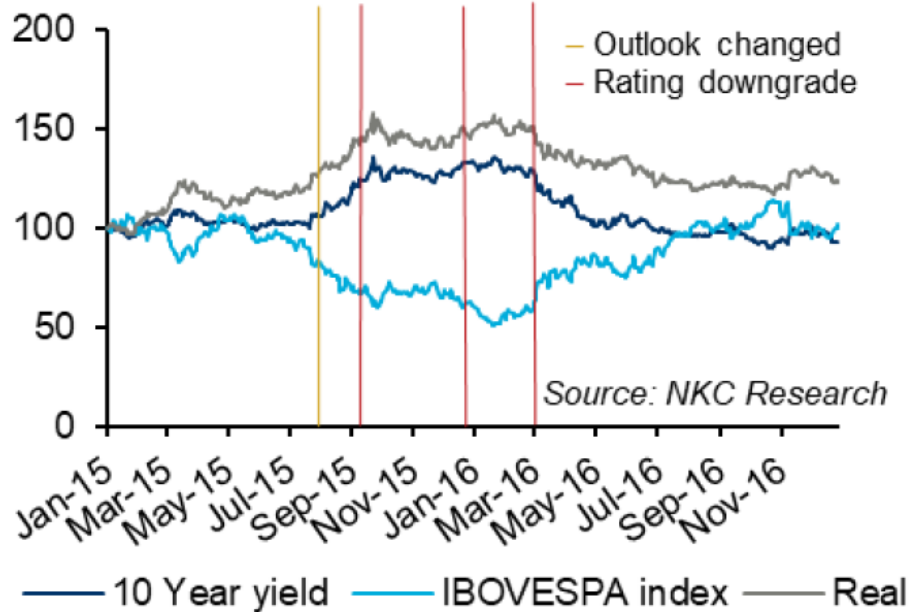
Any improvement – globally (trade war, growth outlook or weaker USA Dollar) or in SA (fiscal situation, Eskom debt plan, ratings, policy, growth) - could mean a more stable Rand in medium term.





Brazil reaction to rating actions

Indexed at 100



Brazil:

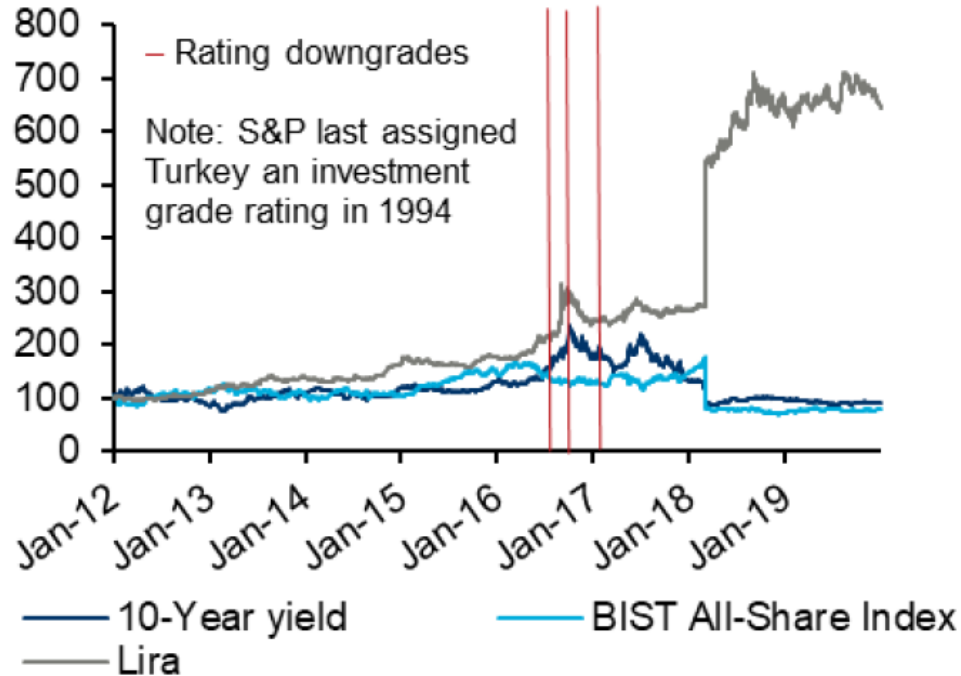
- S&P was the first rating agency to downgrade Brazil to junk status. Similar downgrades by Fitch and Moody's followed.
- Notable market reaction after first change in outlook and rating downgrade, market reaction to further downgrades were much more measured, with some reversals suggesting market overreaction
- 28 July 2015: S&P changed outlook from stable to negative
- 10-yr bond yields up from 13.1% to 15% day before actual downgrade. Real depreciated by 13.7% (vs USD) over same period. Stocks under pressure as well.
- After downgrade, 10-yr yields rose further to 16.8% and Real depreciated 24% as Fitch followed S&P.
- By the time of the Moody's downgrade the market seemed to have fully priced the final downgrade.
- Bonds and currency began to improve.



Turkey reaction to rating actions

Indexed at 100

Source: NKC Research



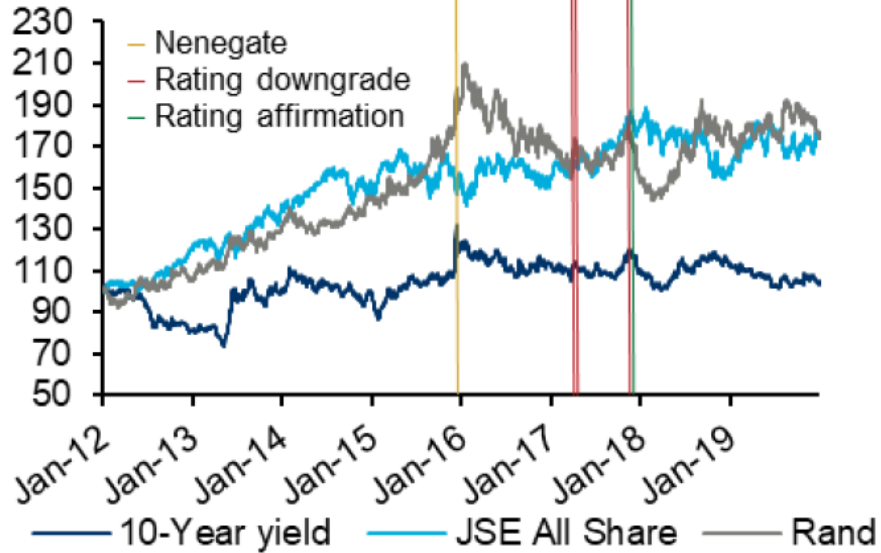
Turkey:

- Moody's was the first rating agency to cut Turkey's credit rating to sub-investment grade in 2016.
- S&P, although cutting its credit rating just before Moody's, did not assign Turkey an investment-grade rating at the time.
- However, the impact of political instability in early 2018 has dwarfed the impact of dropping to junk status.



South Africa reaction to rating actions

Indexed at 100



South Africa:

- Severe market reaction during Nenegate.
- Moody's downgrade will mean SA will drop out of WGBI
- Recent WGBI dropouts were Greece and Portugal. Bond yields rose by around 200bp's in each country – but this was at the time of the severe debt crisis and membership of the European monetary union was at stake and thus perhaps not a fair comparison to SA.
- SA's weighting in the WGBI is around 0.45%. Estimates put the actual amount of capital tracking the WGBI at around \$2trn (Citibank) to \$3trn (Bank of New York Mellon). This implies that funds tracking the index hold between \$9bn and \$13.5bn in South African bonds.
- To put these figures into context, foreign investors accounted for around R750bn (\$53bn) of South Africa's local-currency bonds by the end of October last year, equivalent to around 37% of the R2.1trn government bond market.
- Forced selling, but uncertainty around extent to which active managers without investment-grade mandates will absorb these assets and at what prices.
- BUT global environment (Better growth world ex-USA; EM risk on, weaker USA Dollar) favourable to high-yielding, liquid assets such as those in South Africa.
- Seems that downgrade priced in to currency and bond markets. Some ST reaction expected, but unlikely to be sustained.



But , a reminder...
A lot has been done...



BETTER OUTLOOK FOR SA – A LOT HAS BEEN DONE

Gradually these improvements will lift confidence

- New President, new administration, better cabinet
- Issues such as land reform handled slowly, but in a relative transparent and responsible manner
- Fixing the state – ongoing focus (NPA & SARS heads) (CR: “capable state”)
 - Treasury under Tito Mboweni being rebuilt and gaining confidence and strength
- Fixing SOE’s – a key focus: new Eskom CEO; SAA under administration
 - Eskom corporate restructuring to happen quickly.
- Fighting corruption – some acceleration recently in NPA cases; commissions ongoing
- Keeping institutions strong – highlighted in World Economic Forum’s Global Competitiveness index (see next slide). SARB governor re-appointed.
- Policy debate started (Treasury’s economic plan) – debate ongoing, no implementation yet. Perversely the MTBPS might have helped to focus the minds.
- Visa deregulation has happened and is ongoing.
- Better growth – foundations are being laid.
- Low inflation – helps consumers.
- Lower interest rates – little direct or immediate impact on real economy, but could help confidence
- **Key strengths**
 - Constitutional democracy
 - Independent judiciary
 - Free media
 - Vigorous public debate



South Africa's rating in this index:
strong improvement from last year in
"Institutions" component.

Headline components

2019 vs last year

	2019	2018
	Rank/141	Rank/140
Institutions	55	69
Infrastructure	69	64
ICT adoption	89	85
Macro-economic stability	59	57
Health	118	125
Skills	90	84
Product market	69	74
Labour market	63	55
Financial system	19	18
Market size	35	35
Business dynamism	60	56
Innovation capability	46	46

The good

	2019	2018
Detail within headline components	Rank/141	Rank/140
Budget transparency	1	27
Judicial independence	33	48
Freedom of the press	28	26
Conflict of interest regulation	12	11
Road connectivity	7	5
Cellular subscriptions	10	9
Workers' rights	26	25
Internal labour mobility	18	20
Domestic credit to private sector	10	11
Market capitalisation	2	2
Soundness of banks	29	62
Cost of starting a business	4	4

The bad & ugly

	2019	2018
Detail within headline components	Rank/141	Rank/140
Organised crime	128	125
Homicide rate	135	135
Burden of govt regulation	101	84
Policy stability	108	110
Govt responsiveness to change	110	115
Health life expectatncy	117	124
Quality of vocational training	119	98
Pupil teacher ratio in primary edu	109	107
Hiring and firing practices	129	111
Flexibility of wage determination	134	133
Ease of hiring foreign labour	123	102
Time to start a business	129	128