Many rabbits in the hat
South Africa: A call to urgency

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Key takeaways

- The South African economy has entered a slowdown in 2023 on the back of aggressive global monetary tightening, exaggerated by the domestic electricity crisis and logistics constraints. Potential growth has declined to less than 0.5% as the frequency of load shedding has increased to more than 50% per day (from 47% per day in 3Q 22). There are few growth drivers in the economy, besides more urgency on the government's side to enact structural reforms to address supply-side constraints.
- The key political issues that need to be dealt with urgently will be the cabinet reshuffle, of which the economic portfolios will be critical. The constitutional court ruling on President Ramaphosa's review of the Independent Panel Phala Phala report to Parliament, and Eskom's leadership also need to be addressed urgently. The FATF decision to grey list South Africa or not is expected in February.
- South Africa's fixed income markets and rand have started the year on a firm footing, mainly on the back of external developments such as an earlier reopening of the Chinese economy, and a switch in market focus from inflation to growth. Despite what central banks are saying, the market believes there will be rate cuts before year-end, while the real economic data have also shown some resilience. Hence hopes of a soft landing. The fragile domestic fundamentals, however, will feed into the country's risk premium.
- The international backdrop for risk assets could be more supportive of EM such as South Africa. Positive real interest rates, as energy-driven base effects lead to a moderation in headline inflation, better fixed income valuations after the repricing in 2022, the China reopening and a weaker USD, could see demand for EM FI rise as the carry trade becomes more appealing.
- The manufacturing sector leads the global growth slowdown, but Investec commodity analysts expect price support from very low stock levels for industrial commodities, as well as continuing supply constraints due to long-term underinvestment in new capacity and China's reopening. Gold will benefit from a US interest rate cycle peak and a weaker USD. South Africa's terms of trade are expected to remain relatively stable as the oil price is also likely to rise. Volatility risk in 2023 remains high if risk scenarios such as a higher oil price, stickier inflation in 2H 23, tighter DM monetary policy for longer, and a deeper global economic slowdown, hit corporate earnings and equity markets harder.
- **Macro forecasts:** The SA economy is forecast to grow by 1.0% and 1.3% in 2023 and 2024 respectively. Risks to the growth forecasts are to the downside as government's response to the electricity crisis unfolds. 1H is expected to be more challenging whereas 2H 23 could be more supportive for consumers as real PDI turns positive as inflation recedes to 5.0% and interest rates have peaked.
- **ZAR outlook:** The USDZAR is undervalued in terms of its 13 year real effective exchange rate (REER), but fairly valued over a five-year comparison. The purchasing power parity's (PPP) first standard deviation at 16.30/$ supports a stronger ZAR. We forecast a trading range of R15.80/$ to R17.40/$ (2022: RR14.50/$ to R18.50/$) and an average of R16.60/$ in 2023 (2022: R16.37/$).
- **Interest rates:** Headwinds facing a swift sustainable return of inflation to the inflation target of 4.5% could prolong the battle against inflation. Higher oil prices, the 18.65% increase in electricity tariffs and additional costs incurred to acquire private power sources, could elevate input costs more. We forecast inflation to average 5.6% in 2023 and an average of 4.9% in 4Q 23. The MPC is expected to deliver a final 25bp rate hike at the January 2023 MPC meeting (repo rate 7.25% and 3m JIBAR at 7.45%), whereafter rates could move sideways for the remainder of 2023. The generic SAGB10 yield is expected to trade in a range of 9.70% to 11.0% with the fair value at 10.0% (currently trading at 10.35%).

Global risks

- This is the year of the polycrisis, where risks are more interdepend and reciprocally damaging than ever (WEF, January 2023).
- Energy supply crisis
- Heightened geopolitical and geoeconomics confrontation with the weaponization of economic policy (WEF, 2023), eg. sanctions, trade wars and investment screening. US-China competition/China-Taiwan/cyber attacks/.
- Russia/Ukraine war continues with no permanent ceasefire.
- Global stagflation in 2H 23.
- Deeper US and Eurozone recession as interest rates rise and stay higher for longer as demand remains strong.
- China reopening leads to higher commodity and oil prices and inflation accelerates in 2H 22.
- US debt standstill fallout.

SA-specific risks

- Unresolved electricity crisis and load shedding of Stages 6 – 8 becomes permanent.
- Inflation accelerates to 6.0% in 4Q 23 and SARB hikes rates further.
- Flareup of socio-political tensions, like the July 2021 riots, amid the runup to the 2024 elections.
- Water crisis (as in Eastern Cape) and a further deterioration on the rail and port side.

TABLE 1: GDP GROWTH FORECAST

	2019	2020	2021	2022E	2023F	2024F
GDP (%, annual)	0,3	(6,3)	4,9	2,2	1,0	1,3
Private consumption, real	1,2	(5,9)	5,6	3,0	1,4	2,3
Personal disposable income, real	0,9	(4,5)	5,6	2,2	0,5	2,6
Government consumption, real	2,1	0,8	0,6	1,3	0,4	0,9
Fixed investment, real	(2,1)	(14,6)	0,2	4,8	3,0	3,2
Exports of goods and services, real	(3,4)	(11,9)	10,0	9,4	6,6	4,7
Imports of goods and services, real	0,4	(17,4)	9,5	15,7	8,0	6,2
Employment, total	(0,3)	(7,9)	(2,5)	4,4	(2,7)	0,8
Unemployment rate	28,7	29,2	34,3	34,8	35,4	35,9
Main budget deficit (% of GDP)	(6,1)	(9,8)	(5,1)	(4,9)	(4,8)	(4,5)
Current account of BoP (% of GDP)	(2,6)	2,0	3,7	0,1	(0,5)	(0,6)
Consumer price index (%, annual)	4,1	3,3	4,5	6,9	5,6	4,7
Policy rate (%) (e-o-p)	6,50	3,50	3,75	7,00	7,25	6,50
3m JIBAR (%)(e-o-p)	7,06	4,38	3,88	7,25	7,35	6,40
10yr SAGB yield (%)(e-o-p)	8,95	8,92	9,65	10,86	10,10	9,80
USDZAR (annual)	14,5	16,4	14,79	16,37	16,60	16,00

Source: SARB, National Treasury, StatsSA, Bloomberg, ICIB

TABLE 2: KEY SA EVENTS TIME LINE IN 1Q 23

January		February		March	
26-Jan	MPC (+25bp) Cabinet reshuffle	**09-Feb**	State of the Nation address Budget tabled in Parliament FATF decision	**7-Mar**	SA GDP Q4
				30-Mar	MPC Eskom CEO Constitutional court ruling on Phala Phala review

Source: ICIB

Political anticipation for 2023 (Professor Dirk Kotze)

ANC programme: The early stages of 2023 are dominated by the outcomes of the ANC's National Conference and its 8th of January annual statement. The January statement should be seen as its annual programme of action statement prepared by its National Executive Committee. It follows on its National Conference, and therefore no new announcements appeared in it. This statement sets the scene for an ANC and cabinet lekgotla, which prepare for the State of the Nation address (SONA) at the end of January and the national budget speech in February.

President Ramaphosa consolidated power in the ANC elective conference: The National Conference was dominated by leadership elections. Its task to formulate new party policies received less attention, and therefore most of it was postponed to the first week in January. Most important for 2023 was the re-election of Cyril Ramaphosa as ANC President, followed by the election of another four of his associates in the ANC's Top 7 leaders. The significance of Paul Mashatile's election as Deputy President is not yet clear, because the outcome of the 2024 national elections will determine what the national leadership corps will look like in about two years' time. Mashatile will almost certainly succeed DD Mabuza as national Deputy President, once Mashatile has become a member of Parliament.

Ramaphosa's presidential status is presently much more consolidated than before the National Conference. His majority in the election was the most of the Top 7 positions. The challenge by President Zuma, Zweli Mkhize and the KZN in the ANC did not materialize in any significant results. One can conclude that it signalled the end of the Zuma era in the ANC – he will still be a presence in KZN but not on a national level anymore.

Phala Phala Constitutional Court review as a source of political risk: Phala Phala is a source of uncertainty only from a criminal prosecutorial point of view, and that depends on he Constitutional Court's review of the parliamentary panel's report. If it is set aside by the court, its prosecutorial potential is almost naught, even while the investigative reports of the Public Protector, Hawks and others are still outstanding.

Cabinet reshuffle: The implication for government is that changes in the cabinet are very likely. The new ANC Secretary General, Fikile Mbalula, has to resign as Minister of Transport while Mabuza will be replaced by Mashatile as Deputy President. Lindiwe Sisulu and Dr Dlamini-Zuma, who called for Ramaphosa's resignation before his election, cannot reconcile their stance with continuing as cabinet members. Other members have lost support in the ANC by not being re-elected as NEC members. It is almost inevitable that Ramaphosa will have to appoint a new cabinet who will support his economic philosophy and the anti-corruption policy.

ANC resolutions: The National Conference strengthened Ramaphosa in his economic policy/philosophy. A few pointers which indicate this are:

- the resolution on the SA Reserve Bank (to rescind the 'nationalisation' resolution of 2017 and proposed changes to its constitutional mandate)
- land redistribution (to move away from land expropriation without compensation and concentrate on the state's responsibility to implement land redistribution in general)
- changes in the state-owned enterprises to remove them from the Department of Public Enterprises (including Eskom to the Department of Mineral Resources and Energy).
- The strengthened position of the Finance Minister, Enoch Godongwana.

Governance and service delivery: During 2023, the emphasis on governance and service delivery will be the main government priority. Over the last number of months, a narrative has emerged of separation between the political management of government and the civil service. In all the years since 1994, such a separation was inconceivable, and it dove-tailed with the ANC's policy of cadre deployment. Given the dramatic decline in the quality of government services, it is now challenged. Late in 2022, the cabinet approved new guidelines and legislation about professionalization of the public sector.

For the ANC government to continue with its notion of a developmental state, development of state capacity is an absolute requirement. Its absence has forced the Ramaphosa administration into approaches towards the private sector, such as a social compact, sectoral plans and private-public partnerships. This new policy direction will continue in 2023, because it constitutes the backbone of a new energy formula and funding for renewable energy (climate change).

Countdown to general election in 2024: The 2024 national and provincial elections will be held in during May/June 2024. Though 2023 will be a year in the shadows of these elections, the official election campaigns will commence in January 2024. An important new element of these elections will be inclusion of independent candidates in both types of elections. The parliamentary amendment of the Electoral Act for this purpose had been delayed twice, but the main features of the new electoral dispensation have already been established. In theory, it can introduce radical changes in parliamentary representation, but in practice it is anticipated that political parties will still dominate the nomination processes of the new individual candidates. It will therefore not change the parliamentary representation as much as some political commentators are predicting.

Transitioning into coalition government: These elections will signal a political transition process from the ANC's single-dominant party system since 1994, to a coalition political system for the foreseeable future. Since 2016, it has been present in the local metropolitan governments. For the first time in 2024, it might become a reality also for the national and some provincial governments, such as Gauteng. A number of coalition scenarios are available, focused on either a national grand coalition of the ANC, DA, IFP and other parties, or a DA-led coalition or an ANC-led coalition. At present, the EFF does not fit in any of these scenarios, but the final determination will depend on the election results and combinations of parties who can constitute a majority. Lessons learnt from the local elections are that coalitions become increasingly unstable when more small parties are included. A national or provincial coalition will therefore avoid them, which will exclude parties like the Patriotic Alliance or al-Jamaa.

Election predictions are always high-risk exercises, but some of the surveys so far suggest the following: ANC 40-45%, DA 20-24%, EFF 10-12%, IFP 5%, ActionSA 3-5%, FF+ 2% and the other parties less than 1%.

BRICS and Saudi Arabia: In 2023, South Africa is the chairperson of BRICS. Membership of Saudi Arabia will be a key issue. Funding of the Just Transition will continue to be a major diplomatic initiative for the Ramaphosa administration.

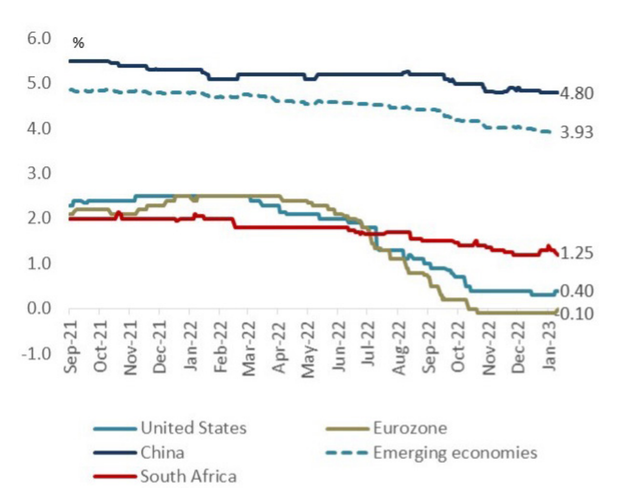
South Africa's growth challenge

The economy is forecast to grow by 1.0% in 2023 from an estimated 2.1% in 2022. Risks to growth are to the downside. The potential growth rate has receded to 0.5%, according to SARB November 2022 estimates. Growth will be driven by household spending and gross fixed investment although their contribution to GDP is likely to be less than in 2022. The SARB estimated that load shedding could subtract 0.6ppt of GDP growth in 2023 (Source: November 202 MPC statement). However, this assumed mostly Stages 2 to 4 as opposed to higher stages of load shedding.

Analysis by the SARB in its December 2022 Quarterly Bulletin showed that load shedding has a significant negative impact on total real GDP growth and on the subsectors.

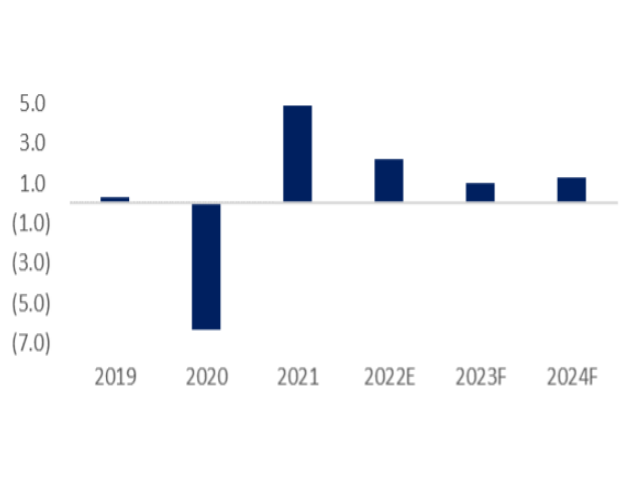
The subsectors most affected were agriculture, forestry and fishing; manufacturing, mining; transport, storage and communication. The SME sector is likely to be under considerable pressure from the intensification of load shedding both from an affordability perspective but also weaker demand. While we do not expect major job losses in the formal sector, this will make it difficult to build on the 1.2m jobs created since Covid-19 and the risk of job losses in the SME sector, has increased. A solution is to allow Eskom to use Open Cycle Gas Turbines (OCGT) peaking power stations more intensively, while waiting for 3000MW of power from Kusile, Medupi and Koeberg. However, burning more diesel, requires more cash. This is an important assumption in the growth forecast, which currently remains fluid.

Figure 1: Bloomberg consensus GDP growth forecast – 2023



Source: Bloomberg, ICIB

Figure 2: SA GDP forecast



Source: SARB, ICIB

A. Load shedding and affording diesel

2022 recorded more than 200 days or 1 363 hours of load shedding. The New Year has seen the implementation of Stage 6 load shedding indefinitely Load shedding has reached an all-time high in January 2023, with nearly a week of Stage 6 load shedding at the time of writing. Eskom's energy availability factor (EAF) for the coal fleet has declined to around 46% and overall plant across the Eskom fleet to 50%, as SA industry has started up again.. Generally, we can expect that load shedding will persist for the following years;

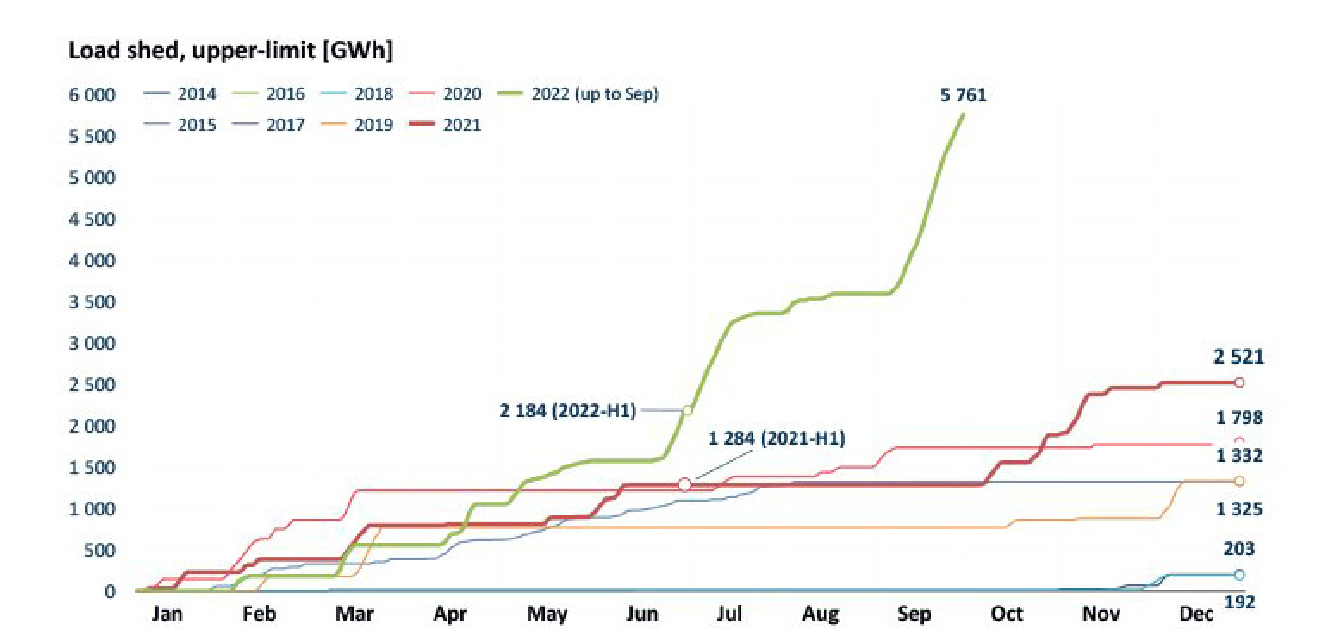
- Load shedding stages at levels 4 to 8 for at least the next 2 to 3 years i.e. until September 2025;
- Load shedding stages at levels 2 to 4 for at least the following 6 to 8 years i.e. until 2032;

The intensification in load shedding was exaggerated by issues surrounding the burning of diesel. The regulator, Nersa, had approved a 2% load factor for Eskom's diesel-fired peaker station, with a diesel budget of R6.1bn for FY22/23. By Oct 2022, Eskom had already spent R11.1bn on diesel over and above the approved budget amount. Nersa granted Eskom a tariff increase of 18.65% and 12.74% for F23/24 and F24/25 respectively. It only allowed Eskom a load factor of 6% (R8.4bn) compared to the application of 12%. Eskom will need at least an additional R16.0bn to avoid the worst case scenario.

At a January 2023 brief, Eskom provided a statistical forecast of load shedding over the next 10 months. The forecast showed that until August 2023, SA would experience Stage 3 load shedding on most days of the month, provided that diesel was burned to make up for the shortfall. The diesel required to keep the system at Stage 3 varied from R3 billion to more than R7 billion a month. As burning this amount of diesel is physically and logistically impossible, the implication was that load shedding would in fact, be several stages above Stage 4.

Note that the problem with trying to predict how much additional diesel will be imported and its costs is difficult, because there are also logistical bottle necks. ESKOM pays about R15/litre for diesel so 3,33 m l/d over the past year. Depending on the number of days in the year they operate the plants, these costs could be somewhere between R12bn and R18bn per year for diesel to try and have load shedding reduced.

Figure 3: Upper limit of cumulative loadshedding Jan 2014 – Sep 22



Source: CSIR

Eskom debt restructuring:

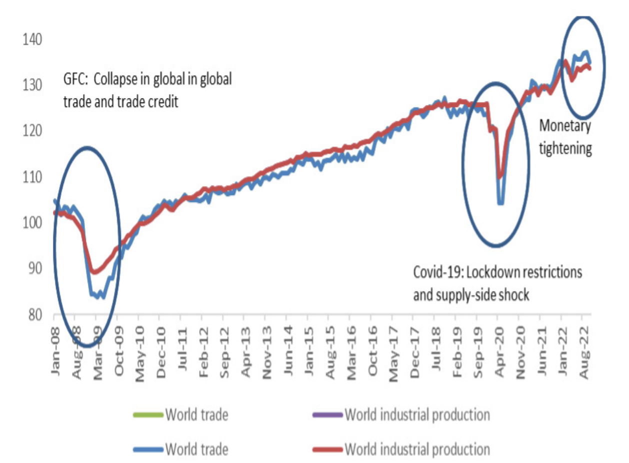
A decision about Eskom's debt restructuring is expected in the February 2023. The Minister of Finance announced in January 2023 that National Treasury will take on a portion of debt in a staggered manner, to avoid a spike in the country's debt-to-GDP ratio. This could most likely result in an extension of the R23bn per annum cash injection to Eskom, which we previously thought could be directed to debt servicing costs. This is also probably to support Eskom's cash flows to acquire diesel. Nersa's record of decision, i.e. the allocation of revenue to different line items, has not yet been published.

B. Macro economic dynamics

- **Global trade:** Net trade could make a smaller contribution to economic growth in 2022 as the manufacturing sector is leading the global growth slowdown. The World Trade Organisation (WTO) forecast global merchandise trade volumes to grow by 1.0% in 2023 from 3.5% in 2023. The slowdown/possible recessions in the United States and Europe will soften demand for imports. The reopening of China is likely to be consumer driven and less commodity intensive. The property sector needs to rebound, which is not a base case scenario, for firmer growth in commodity prices. However, our commodity analysts expect commodity prices to remain relatively high, owing to supply shortage shortages and underinvestment in many commodities.
- **Supply-side:** The dire state of South Africa's supply side of the economy is reflected in activity levels that have not returned to pre-Covid 19 levels, except financial and business services and agriculture. The operating environment for mining and manufacturing companies will remain challenging as supply chain stability needs to be improved with the logistics crisis at Transnet; price improvements are being negated by the decline of output volume/production due to the power crisis and only 1000MW of self-generation projects of around 7000MW will come online in 2023.
- **Demand-side:** Growth in 2022 was driven initially by consumption spending, as the lifting of Covid-19 restrictions and pent-up demand led to Covid-19 savings being spent (e.g. Durable good spending returned to pre-Covid 19 levels), restocking and net exports.
  - **Consumption spending** is forecast to grow by 1.5% in 2023 from 3.0 % in 2022. Savings accumulated during the lockdown period, were utilised, i.e. household bank deposits relative to gross disposable income stood at 110% in 1Q20, rose to 143% in 2Q20 and subsequently declined to 119% in 3Q22. Household debt remained contained at 62.8% of PDI in 3Q 22, marginally above pre-Covid level of 62.5% of PDI. Lending standards have remained relatively tight, reflected in a moderate increase in unsecured lending and driven mostly by mortgages lending and instalment sales credit. However, debt servicing costs have increased from 6.8% of PDI to more than 8.0% on the back of aggressive rate hikes, which is feeding into weaker consumer spending. Nominal wage increases of 6.0% are expected in 2023, which indicates that 2H 23 could see better prospects as inflation recedes and the rate hiking cycle has ended. The extension of the Social Distress of Relief grant (SRD) and an inflation adjusted increase in social grants, will provide support to low income groups. ICIB forecasts a moderation in personal consumption spending from 3.0% in 2023 to 1.5% in 2023.

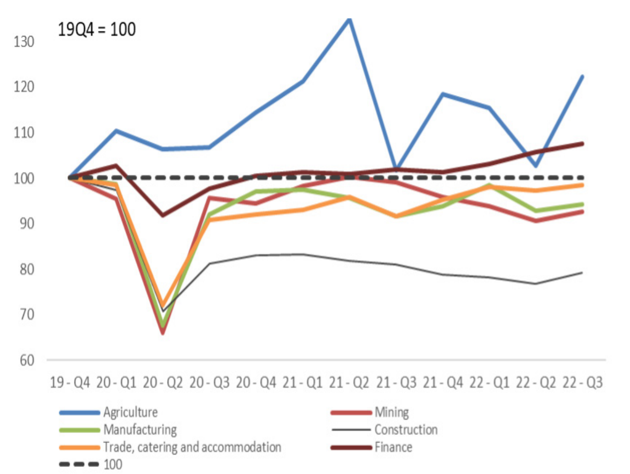
- **Fixed investment** in 2023 is highly dependent on the political will to address the electricity crisis. While private sector fixed investment remains well below pre-Covid 19 levels, there has been an acceleration in categories such as transport equipment, and residential and non-residential buildings. Fixed investment in renewable energy projects is expected to accelerate in 2023 (ICIB forecasts projects of R60bn of fixed investment) with more momentum in 2024 (R85bn). The weak financial positions of SOE's such as Eskom and Transnet remain challenging, i.e. Transnet has put out a tender for repairing Chinese locomotives. Finally, business confidence will take a hit from the intensification of load shedding. We forecast an increase of 3.1% in 2023 from 4.8% in 2022.

Figure 4: Global trade is slowding down



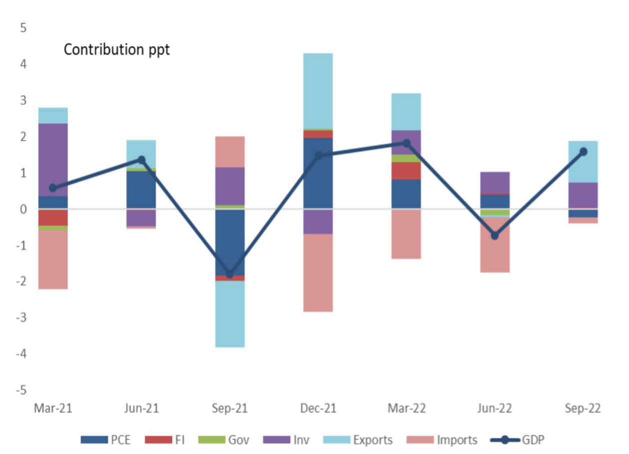
Source: Bloomberg, ICIB

Figure 5: SA supply side is struggling



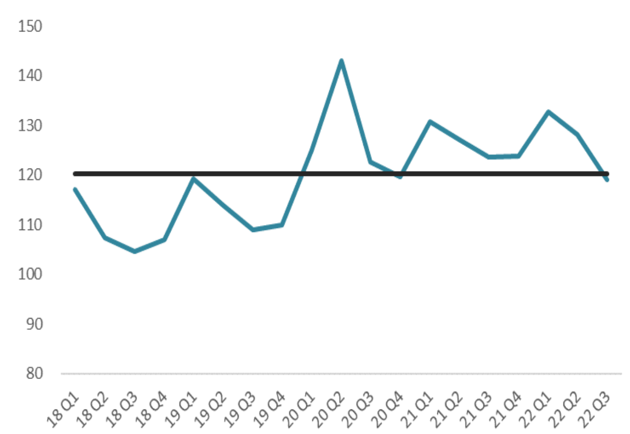
Source: StatsSA, ICIB

Figure 6: Demand contribution to GDP – Rebuilding of inventories



Source: SARB, ICIB

Figure 7: Household bank deposits relative to gross disposable income (%)



Source: SARB, ICIB

Inflation outlook

Inflation ended a long way off from initial 2022 predictions of 4.9% to an estimated 6.9%. In 2023, ICIB forecasts an average of 5.6% in 2023, with a year-end rate of 4.9%. Base effects from the acceleration in food and fuel prices in 2022, and a decline in January 2023's energy prices, will do most of the heavy "pulling" to lower inflation in 2023. Inflation could retreat sharply from more than 7.0% in 4Q 22, 5.5%. 5.5% in 2Q 23, and 4.9% in 2H 23. The drivers of inflation volatility namely food, fuel and electricity, will again be the dominant drivers in 2023.

- **Oil price to rise:** The oil price is an important risk to an earlier return of inflation to Central Bank targets. Global recession fears, dominated in the new year and the oil price briefly slipped to 80$/bbl before returning to $85/bbl). Our energy analyst, Herbert Kharivhe, expects a volatile price in 1Q 23 as the markets process China's reopening and the depth of the expected US recession or economic slowdown. However, thereafter a meaningful pickup is expected from 2Q and 3Q. Herbert forecasts an average oil price of 98$/bbl in CY23 (92$/bbl H1 and 105$/bbl in H2), with the SARB's average of 92$/bbl. The drivers are:
  - US commercial inventories are at 2014/15 levels, despite the largest historical Strategic Petroleum Reserve (SPR) (240 million barrels) released in 2022. Demand is +/- 10 million barrels per day higher relative to 2014/15,

    and therefore requiring more storage/inventories. The SPR is at levels last seen in the mid-80s.

    - Oil is undersupplied (+/- 275 million barrels) in 2023, with prospects of increasing demand from China's reopening.
    - Further supply could decline as a result of the price cap on Russian sea-borne crude oil exports, and the pending ban on refined petroleum products (effective 5-Feb-23).
    - We flag the low OPEC spare capacity which consists of Saudi Arabia (+/-1.5 million barrels per day) and UAE (1 million barrels per day).
    - US shale can underwhelm in 2023, as companies continue to favour shareholder distributions (dividends and share buybacks), over production growth.

  - **The implication for the fuel price in South Africa is an average of 2.5% compared to 34.4%. This reflects a reversal of the sharp decline of more than R2.00/l in January with increases recommencing in March 2023.**

- **Food price inflation to moderate:** Food price inflation peaked at an estimated 12.9% in December 2022, averaging 9.5% in 2022 compared to 6.5% in 2021, with grain, protein and oils and fats the key drivers of higher inflation. In 2023, Investec's food analyst, Anthony Geard forecasts a moderation in food inflation to an average of around 6%. (SARB 6.2%). Food inflation has peaked in 4Q 22. The anticipated moderation in 2023 will be more from base effects as pressure on input costs can still translate into upward monthly adjustments, but on a smaller scale. At the margin, lower freight charges, a stronger rand and a reduction in transport costs reduce pressure (temporarily). But load shedding translates into wastage. The decline in the maize price will reduce pressure on grain inflation, and soft commodities could benefit from good rainfalls. But protein prices such as poultry, could remain under upward pressure.

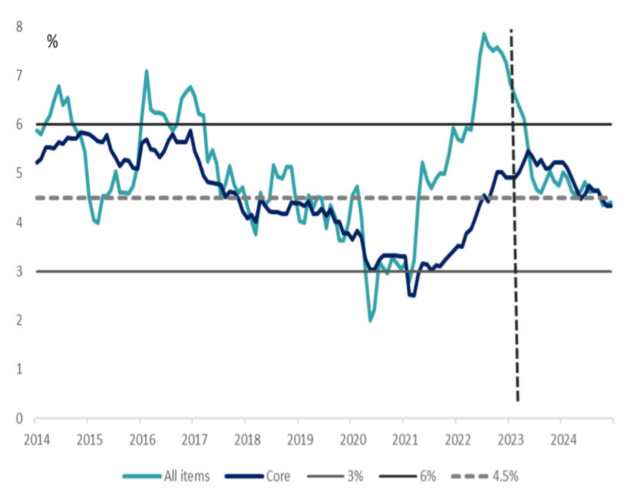
- **Electricity tariff increase:** Nersa granted Eskom a tariff increase of 18.74% in F23/24 and 12.68% in F24/25. This adds nearly 0.6ppt to July 2023's CPI inflation rate, depending on the margin added by municipalities. . The SARB pencilled in 10.4%, which implies a lift to their inflation forecast in 2H23, although we see only a small increase in their average inflation forecast of 5.4% for 2023. Higher input costs, however, could contribute to stickier core CPI inflation, forecasted to average 5.5%.

- Nominal effective exchange rate: Following a 14% variance in the trade weighted index of the ZAR and 27% in the USDZAR, we expected the ZAR to be on a steadier footing in 2023, owing to the reopening of the China economy, and higher for longer commodity prices. (See analysis below). We forecast the rand to average R16.60/$, with a year-end rate of R16.30/$. The output gap could stay more negative as the growth outlook deteriorates, but potential GDP has declined to 0.5%, according to SARB November 2022 forecast.

What are the risks?

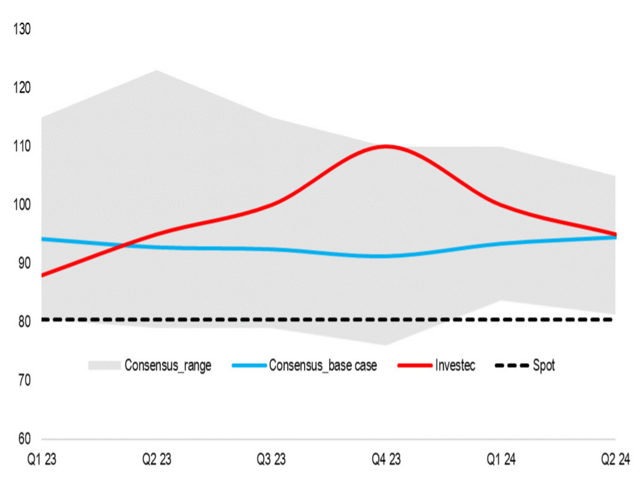
- A steeper rise in the oil price as geopolitical risks remain high.
- A ceasefire in the Russia/Ukraine war could lead to a decline in the oil price.
- Steeper fuel tax increases, i.e. GFIP maintenance as the Gauteng province takes over responsibility.
- An appreciation in the USD if sticky US inflation leads to the Fed raising the terminal rate well above current market pricing of 5.0% and the USDZAR averaging R17.50/$.

Figure 8: Headline and CPI inflation forecast



Source: StatsSA, ICIB

Figure 9: Oil price forecast



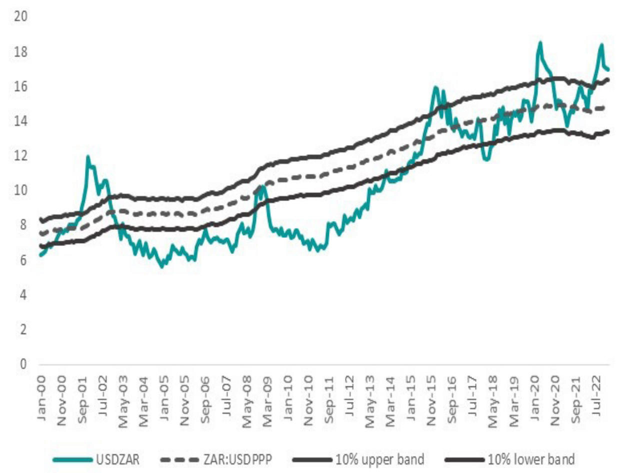
Source: Bloomberg, Investec Securities

Whither the US dollar and the ZAR?

The current account balance is anticipated to record a small deficit of -0.7% of GDP (surplus of 0.1% in 2022). Demand for diesel could see an increase in import volumes, in addition to investment into infrastructure. Export volumes, however, will be impacted by the logistics crisis and slower global growth. South Africa's terms of trade, however, could be relatively stable to weaker as the prices of South Africa's exports commodities remain steady at high levels, whereas the oil price could return to $95/bbl.

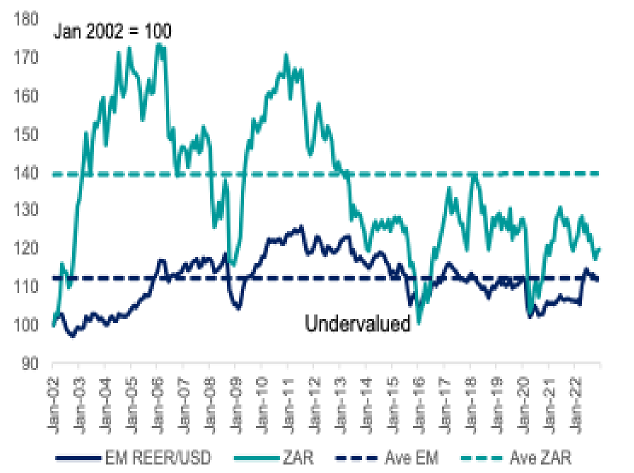
- **Rand valuation:** The rand is undervalued according to a long-term PPP measurement of approximately R16.40/$ of its first standard deviation but fairly valued when using the 5yr average REER.
- **Volatility risk remains:** While volatility risk remains, as discussed before, the external backdrop is more favourable with the reopening of the Chinese economy and a moderation in European inflation as gas prices have returned to pre-Russia's invasion of Ukraine in February 2022. However, USD weakness is not a foregone conclusion and coming months could see some volatility.
- **SA/US inflation differentials:** Finally, we note that SA/US inflation differentials are expected to widen as US inflation drops off faster than South Africa, where the more substantial increase in Eskom's tariff increase have lifted 2H 23's trajectory.
- **Carry trade:** The rand's appeal as a carry currency in the front-end of the curve has been less attractive then Latin American and Eastern European currencies, owing to a relative more moderate rate hiking cycle. Another factor is that the ZAR is no longer a major positive carry currency in the front end of the curve, as rate hikes were more muted than in Latin America and Eastern Europe. However, with Latin American Central Banks embarking on an earlier easing cycle, the ZAR could become more appealing in 2H 23. A dynamic that needs to be flagged is that the gradual ending of yield curve control (YCC) in Japan might remove a source of carry trades (as the ability to fund a position in near-zero, stable rates would be removed).
- However, SA specific risks have increased and could lead to ZAR underperformance vs other EM FX.

Figure 10: PPP of the ZAR



Source: Bloomberg, ICIB

Figure 11: Real effective exchange rate of the ZAR



Source: Bloomberg, ICIB

Rate hikes close to the peak but higher for longer?

2022 will be remembered for the repricing of global interest rates, following more than a decade of zero-bound and negative policy rates and quantitative tightening. The US yield curve has inverted as the market is pricing in Fed easing over the next two years, starting 4Q 23. The German bund curve could be inverted after the ECB delivers another50bp rate hike at the February interest rate meeting. Current market pricing is for the Fed to end hiking rates by March/May, delivering two more hikes of 25bps each, taking the terminal rate to 5.0%.

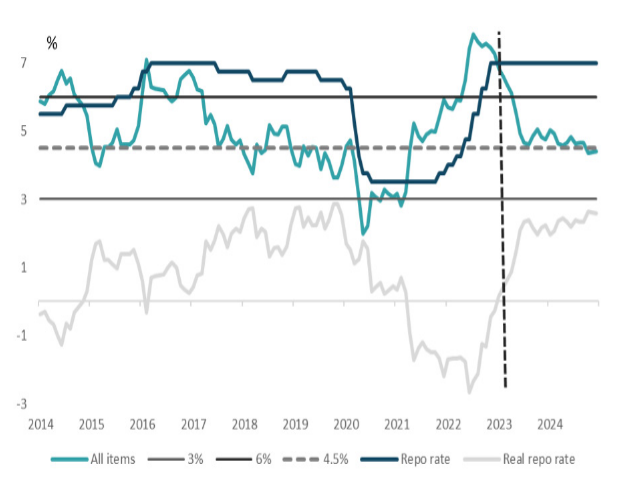
In South Africa, the MPC raised the repo rate by 325bp to 7.0% in 2022, owing to SA/US interest rate differentials and the rand, and rising inflation expectations as headline inflation accelerated to more than 7.0%. We forecast a final rate hike of 25bps at the January MPC meeting and a terminal rate of 7.25%, which implies a more restrictive policy stance. Real interest rates could turn positive with January 2023's CPI inflation print (F:6.9%), and to 2.25% in 2H 23. However, our inflation forecast suggests that inflation remains approximately 50bp above the mid-point of the target band, which could keep the MPC on hold for the remainder of 2023.

The key drivers of the aggressive rate hiking cycle in 2022 were SA/US interest rate differentials and the rand, and inflation expectations as headline CPI inflation rose beyond 7.0%. Monetary policy could become more restrictive in 2023 as the policy rates becomes more positive. However, as discussed in the FX section, South Africa's short-term interest rates are not offering the highest carry trade pick-up. The rand is becoming more vulnerable to global dynamics as the current account records a deficit combined with fragile fundamentals, and the country risk premium will remain wide.

Repo rate: Current 7.00%; 1Q 23F: 7.25%   4Q 23F: 7.25%

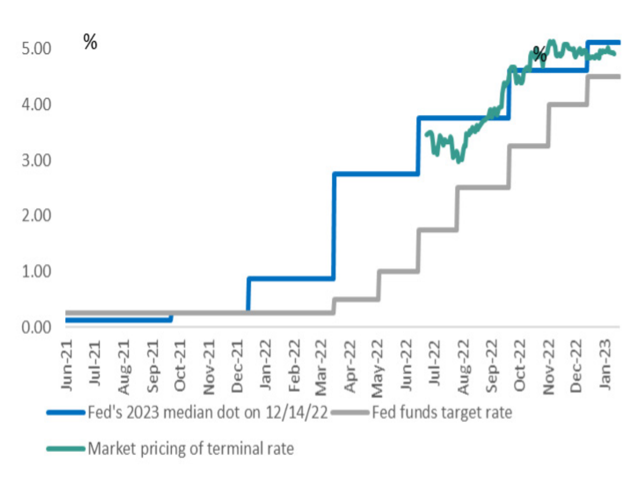
Fed funds target rate: Current 4.50%; Q1F: 5.00%; 4QF: 5.00%

Figure 12 : Inflation adjusted repo rate turns positive from January 2023



Source: SARB, ICIB

Figure 13: Market expects US terminal rate to peak at 5% in March/May 2023



Source: Bloomberg, ICIB

Fiscal metrics as good as it gets

Fiscal consolidation has made progress since the Covid-19 pandemic. The main budget deficit widened from 6.1% of GDP in F19/20 to 9.8% of GDP in F20/21. A meaningful overrun in revenue receipts, partly owning to conservative forecasts by National Treasury, but also on account of windfall tax payments by mining companies in the past two years, allowed for the side step of a fiscal cliff. The main budget deficit is forecast to reach 4.9% of GDP in F23/24. National Treasury carefully balanced the revenue windfall by allocating half to debt reduction. Spending has been contained but the many unforeseen events have persistently required additional financial assistance.

The budget to be tabled in February 2023, will again be dealing with a range of outstanding issues that have been rolled over. These include not only the outstanding public sector wage settlement for F22/23 but also the new round of wage negotiations (this is likely to be rolled over to the October 2023 MTBPS). An inflation adjusted social grant, SOE bailouts and Eskom's debt restructuring will feature most prominently, in addition to a revision to macro economic forecasts and revenue assumptions amidst the electricity crisis. Sovereign credit ratings are expected to remain unchanged following upgrades in 2022, as the costs of the electricity crisis on growth and tax receipts unfold (Moody's, Ba2 stable and S&P BB – positive).