SA Sovereign Bonds: Keep the faith and stay the course

Tito Mboweni, the Finance Minister delivered one of the most closely watched Medium Term Policy Statement(s) (MTBPS) on 30 October. During and post the speech, the market reacted quite negatively to the picture painted by Minister Mboweni. In lieu of the market reaction, we felt it necessary to provide a summary of the speech.

The 2019 budget estimates that the total revenue shortfall for 2019/20 will amount to R52.5 billion. This was a reflection of poor economic growth. As a result of tough trading conditions and rising unemployment, corporate income tax receipts were lower than expected. Unexpected VAT refunds, in line with commitments in the 2018 MTBPS, accounted for a budget shortfall in the current year.

The downward revision to domestic growth this year to some 0.5%, growing slowly to 1.7% at the end of the MTBP period, has resulted in lower revenue projections over the coming years. The current account deficit is expected to remain at 3.5% of GDP over the next three years, due to weaker domestic demand. The primary sources of government expenditure – social grants, education and health – constitute 48% of the total R6.3 trillion spend over the next 3 years.

What appears to have spooked the market is the expectation that the budget deficit will average 6.2% of the GDP over the next 3 years. Debt and debt service costs will continue to increase, with the debt-to-GDP ratio now estimated at 71.3% in 2022/23. The potential for this to deteriorate by more than the MTBPS estimates is a concern. The other major concern was the increase in the public sector wage bill. Minister Mboweni announced several measures to attempt to manage the wage bill; amongst them a wage freeze on Cabinet, Premiers and MEC's salaries for the foreseeable future and caps on public official's car allowances at R700 000 VAT inclusive. Regardless, growing debt-to-service costs and the wage bill continue to be major concerns in lieu of social inequalities that exist in South Africa.

The elephant in the room continues to be Eskom. Minister Mboweni highlighted that the government will provide medium-term support to Eskom to honour its contractual obligations. National Treasury in conjunction with the Department of Public Enterprises is expected to bring some financial discipline to the troubled electricity provider. This is expected to be an expensive exercise, with R230 billion to be spent on Eskom and the energy sector over the next 10 years. The blueprint for transforming Eskom has already been provided but implementing reforms that will please all parties remains elusive.

The currency market provided a justified knee-jerk reaction to the picture painted by Minister Mboweni. The change to negative outlook by Moody's seems all but done. That being said, the key take-away from the MTBPS is that if tough decisions are not made now, the road the country is going down will not be a pleasant one. It is important though not to be reactionary. In an interview, Whitey Basson, the former CEO of Shoprite, highlighted that South Africa through its history has on many occasion faced similarly difficult situations in getting to this point - we must merely make difficult decisions. Minister Mboweni seemed to share these sentiments when he said, "The winter has been long, but we must prepare for spring and reposition the Republic to grow and to thrive. We need to plant good seeds for our country, both now and for future generations."

In conclusion, "Moody's will be pressured to act. Moody's is likely to either place SA on "negative outlook" or "negative watch", implying a downgrade could happen as soon as March next year if no fiscal reforms are implemented. At Sanlam Investments Multi Manager we are conscious of these developments in the market and will keep monitoring the situation. As such, despite the turmoil and uncertainty around the structural reforms the country needs, overall SA sovereign bonds continue to offer attractive real yields.

The portfolio management team will be in touch if any changes impact your portfolio, but we maintain that for the longer term, your portfolios are well positioned and urge our investors to stay focused on their portfolio's objective of long term capital appreciation.

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