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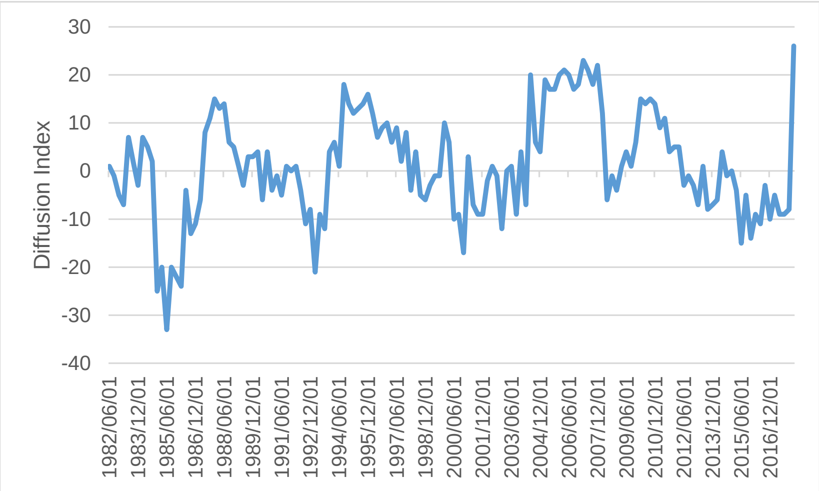
Economic Overview for Business Owners

May 2018

A nascent revival in South Africa's SMMEs?

Available data points to marked deterioration in South Africa's real GDP growth rate in 1Q18. Even so, final demand is lifting, supported by elevated terms of trade, which increased domestic income growth and purchasing power, lower inflation, some monetary policy easing and buoyant confidence levels. Indeed, the South African economy is in better shape than it has been for some time. Note, in particular, the spectacular bounce in household confidence in the first quarter of 2018.

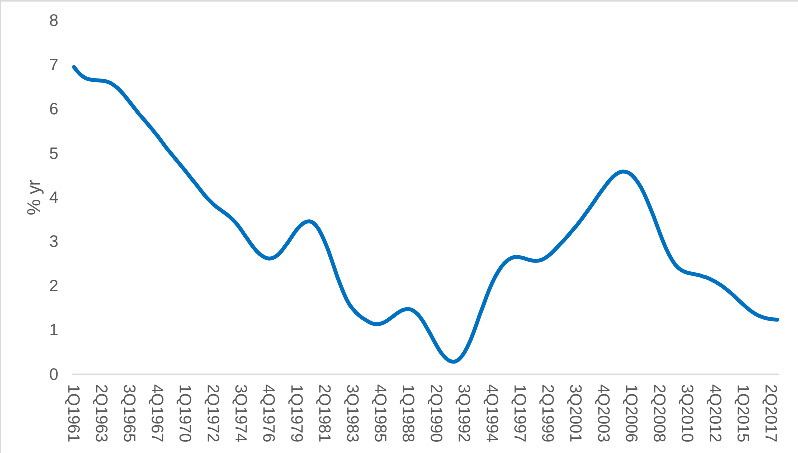
South African BER/FNB consumer confidence index



Source: I RESS

Admittedly, the 1% VAT rate hike effective 01 April 2018 is set to increase inflation by around 0.5%. And, together with the continued increase in taxes on income and wealth relative to personal disposable income, higher inflation in 2H18 is expected to dampen real personal disposable income growth. Also, it remains to be seen to what extent domestic production, as opposed to imports, responds to increased household consumption spending, while the damage from the drought in the Western Cape is yet to be fully reflected in the national accounts data. Nonetheless, it seems reasonable to expect real GDP growth to lift towards 2 per cent over 2018/19 – significantly better than the low, persistently deteriorating trend in growth recorded since 2008. There could even be some upside by next year if economic reforms are implemented.

SA real GDP trend growth

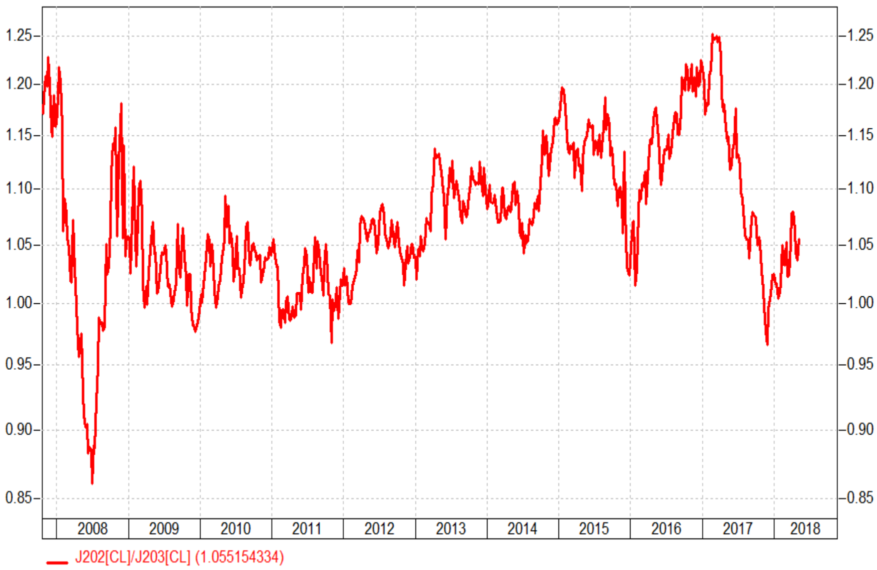


Source: SA Reserve Bank, Sanlam Investments

Small and medium enterprises should benefit, in time, from the generally improved macroeconomic environment, on the assumption that many are significantly exposed to domestic economic outcomes.

Small and mid-cap shares lagged behind their larger counterparts over the year to 1Q18, despite improving domestic final demand conditions. They did, however, gain some ground on a *relative* basis during the first quarter of this year.

JSE Small Cap Index relative to JSE All Share Index



Source: I RESS

One concern, reflected in dented global business confidence indicators in the opening months of 2018, is the risk that deteriorating trade relations between the US and China could spill over into global supply chains, production and real economic activity. Viewed in isolation, the proposed increase in US import tariffs on specific goods imported from China (US$50 billion in 2017) and an expected, similar retaliation from China should not derail real global economic growth or ignite inflation in the near term.

But we should not be complacent. There is the risk of a rapid escalation in tension between the US and China. Also, the current trade spat is one symptom of a worrying trend, namely the apparent drift in US policy away from integration and constructive engagement with the world. For decades the US was instrumental in promoting free trade and economic liberalism, but is now leaning towards trade protectionism (the US also withdrew from the Trans-Pacific Trade Partnership and recently imposed higher tariffs on US steel and aluminium imports from selected countries, including South Africa), has changed its stance on immigration policy and threatens to withdraw foreign aid. It remains to be seen how far the US will drift down this road, but as a general observation a persistent drift towards more restrictive trade practices holds the risk of declining competition, less efficiency and, by extension, the risk of weaker growth and higher inflation in the global economy.

Moreover, the global economic upswing is “long in the tooth” compared with history. In the US, for example, the unemployment rate has declined to just 3.9% and the economy must be running close to full employment. Add the potential escalation of geo-political risk and the risk to emerging markets from the persistent shift of the US Federal Reserve to a less accommodative monetary policy stance and it is clear there is a lot that could go wrong.

Ultimately, though, South Africa can go some way towards mitigating these risks by pursuing an economic reform agenda along the lines proposed by our National Treasury in its 2018 Budget Review. This includes the lowering of barriers to entry for SMMEs, which are the economy’s main employment creators (as promoted in ANC economic policy documentation), acting on the long-awaited release of additional broadband spectrum to enhance telecommunications infrastructure, mining sector policies that promote investment and tackling South Africa’s skills shortage.

I would argue that the positive spin-off from these reforms would likely be an increase in government revenue, lower fiscal policy risk and lower real borrowing costs.

It sounds like a plan worth pursuing and it would go a long way towards establishing an environment conducive to a flourishing SMME sector.

Admittedly, it is likely to be a long and arduous journey, but, as my colleague at Sanlam Asset Management, Vanessa van Vuuren, noted recently with reference to specific small cap shares: “at least the high level trends are starting to point in the right direction for the first time in a fairly protracted period (the last five to seven years)”.

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