Economic Overview for Business Owners

September 2017

Is the profit downturn at a trough?

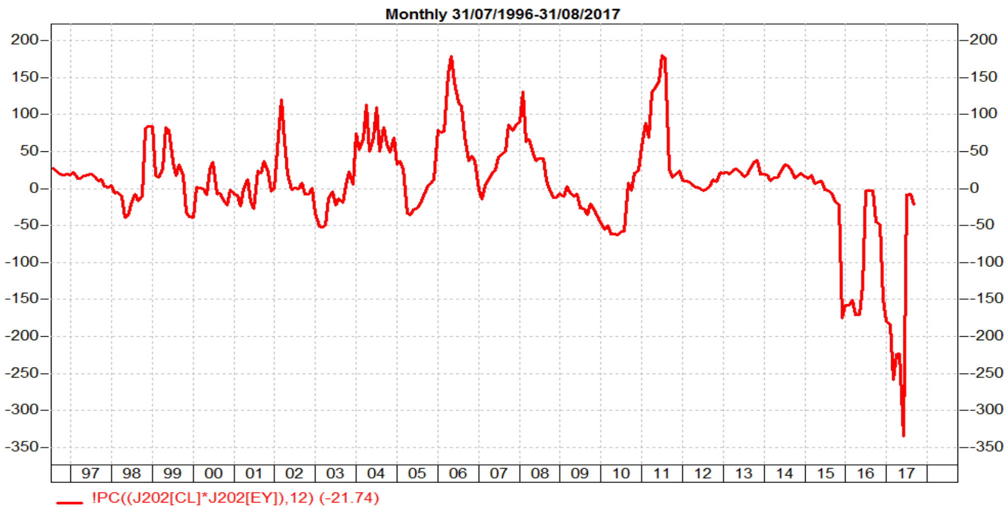
It is odd that South Africa should record a technical recession, reflected in two consecutive quarters of negative GDP growth, including falling manufacturing production and a rising unemployment rate, in the final quarter of 2016 and the first quarter of 2017. A combination of firm real global growth, higher export commodity prices, disinflation and a peak in the Reserve Bank's interest rate hiking cycle should signal the onset of a business cycle upswing, especially since currently there is no "balance of payments constraint" (the current account deficit has narrowed markedly in the past two years).

However, increased manufacturing and mining production, as well as a sharp increase in real retail sales, indicate real GDP recorded a material improvement in the second quarter, probably advancing in excess of 2% seasonally adjusted and annualised.

Although the better GDP data in the second quarter is off a low base, the developments noted above together with a bounce in agricultural production should result in better growth into 2018. An important underlying factor for this cautious optimism is the recorded improvement in our terms of trade. This can be expected to support domestic purchasing power and demand, provided the global business cycle expansion continues and commodity export prices hold up.

Both labour and businesses could do with a more favourable operating environment. In recent years, businesses have needed to cuts costs and constrain labour compensation as domestic corporate profits (national accounts measure, which includes listed and unlisted companies) recorded a persistent decline from 22,6% of GDP in 2007 to 14,9% of GDP in 2016 (its weakest level since 1994). This compares with a long-term mean of 16,7% of GDP.

Small capitalisation stocks' earnings



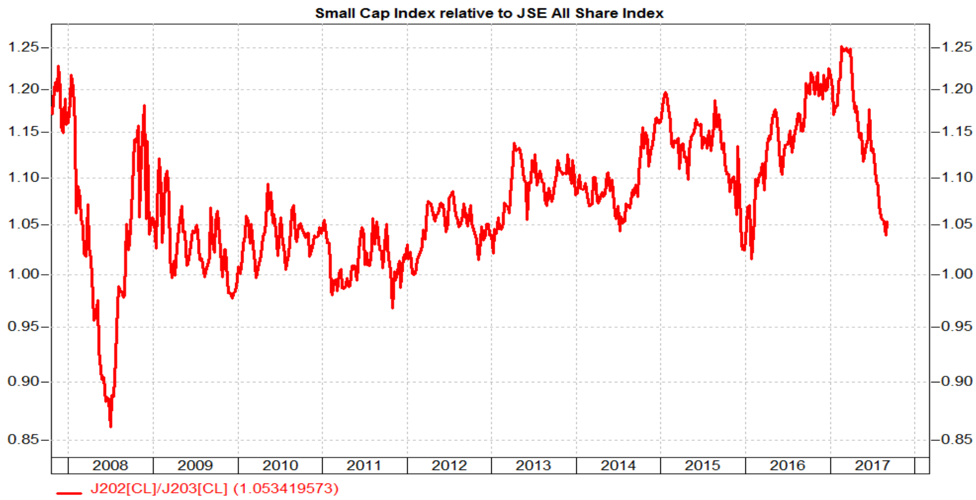
Source: Iress

Small and medium business enterprises, which are arguably relatively more exposed to the domestic economy, were not spared, as reflected in the extraordinary decline in earnings of small-capitalisation shares on the stock exchange. Admittedly, this collapse in earnings was grossly exaggerated by the inclusion of some mining stocks in the Small Capitalisation Index. Still, it is evident that is has been difficult to deal with the prolonged business cycle downturn (to date the second-longest on record for South Africa).

The better news is that it seems as though the earnings downturn has stabilised. This conclusion is supported by the Reserve Bank's national accounts data as reflected in the gross operating surplus of non-financial corporations, which increased by 6% (current prices) in the year to Q1 2017. The Bank notes that to a significant extent this reflects an improvement in the mining industry where profits have been supported by the increase in commodity prices since last year and the depreciation of the rand in previous years.

Even so, the environment remains challenging to say the least for small and medium companies and the Small Capitalisation Index has underperformed the JSE All Share Index by some margin.

Small Capitalisation Index relative to JSE All Share Index



Source: Iress

South African businesses face numerous hurdles, which suggests the return of confidence and renewed commitment to investment are not likely anytime soon.

The Reserve Bank has responded to downside surprises in GDP and inflation prints, but the interest rate cutting cycle is expected to be shallow. Meanwhile, policy uncertainty remains high, including fiscal policy. The softness in nominal GDP (which increased by just 5% in the year to Q1 2017) suggests a sizeable government revenue shortfall is likely this year, which in all likelihood will require additional revenue-raising measures.

Wealth taxes, including a capital transfer tax, a land tax, and a national tax on the value of property, are being considered. But, private business enterprises are not necessarily immune. At the very least, as regards businesses, the National Treasury is likely to focus on base erosion and profit shifting.

In addition, the Treasury indicated in its Budget Review 2017 that it will seek to broaden the tax base, implying a review of deductions (related to excessive debt financing) and incentives (for investment).

The bottom line is tax policy uncertainty is an additional unwanted constraint on investment spending and job creation. The latter is already being held back by weak domestic real economic activity, inadequate returns on investment, a volatile currency and depressed business confidence.

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