24 March 2020

Lockdown hits growth, prevents bigger crisis

President Ramaphosa has announced a nation-wide lockdown for 21 days from midnight on Thursday. This attempt to curb the local spread of the coronavirus and prevent an even deeper humanitarian and economic crisis will, as the president acknowledged, have severe economic consequences, despite laudable interventions to alleviate the impact on the most vulnerable businesses and individuals. We adjust our macroeconomic forecasts (see table overleaf), though it is hard to accurately quantify the impact of such an unprecedented "sudden stop" in the real economy, and we rather stress some of the general themes than any point forecasts, which will also be influenced by the very fluid global economic setting.

- A severe, abrupt growth impact in 2Q20 is inevitable, with the goods-producing sectors and discretionary consumer spending likely to be under particular strain, though most sectors are expected to contract in 2Q20. A sizable share of 2Q20's "lost" production and consumption are actually deferred to subsequent periods, which should, along with the expected global recovery, support a strong growth rebound in 3Q20. Some of the intended production and consumption, however, are permanently lost. We expect a deeper SA recession than during the global financial crisis (GFC), when there was space for strong mitigating domestic fiscal expansion.

- We see scope for further relief from the SARB, although its decisions will likely be very difficult and the extent of easing particularly sensitive to global factors and the trajectory of the rand. Our expectation for further easing is influenced by our sense at the recent MPC meeting that the SARB is reasonably comfortable that 1) inflation expectations are anchored around the mid-point of the target range, which allows more monetary flexibility than what the bank may have regarded as prudent before, and 2) there is little immediate threat from inflation and that, if it acts on the immediate and clear growth concern now, it will have ample opportunity to act timeously in advance of any inflation problem. The inflation outlook is relatively benign despite the rand weakness that we foresee. The rand remains vulnerable in the near term, amid jittery global financial markets, a fragile and weak global economy, occasional thin markets, and the likely expulsion from the World Government Bond Index (WGBI). However, we expect a rebound, even if grinding, in the medium term as the prevailing impact of the pandemic globally fades. Likewise, we expect bond yields to retreat in response to more benign global market conditions, but the weaker fiscal prognosis underpins permanently higher forecasts than before.

- Our cursory estimates are that the interventions announced by government to alleviate the impact on small to medium businesses and low-income individuals should not have a material permanent impact on the main budget deficit; some measures are transitory, and the others might be absorbed by the contingency reserve and savings elsewhere as a result of the likely spending delays during the lockdown. These impacts pale in comparison to the revenue shortfall that seems likely. The main budget deficit is likely to widen to around 9.8% of GDP instead of the Budget 2020 projection of 6.8%, which implies exceedingly high levels of borrowing in the bond market, even with switch auctions. Our long-standing expectation of a sovereign downgrade by Moody's at its rating review on Friday night (27 March) prevails, underpinned by an unsustainable fiscal prognosis that is rapidly deteriorating. Downgrades by Fitch and S&P are also on the cards.

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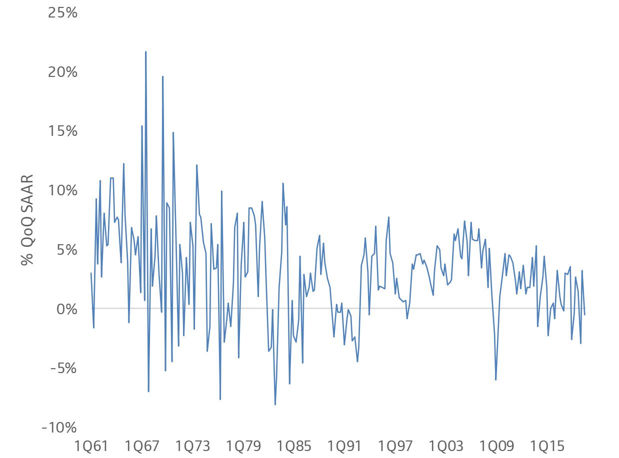
Figure 1: Macroeconomic forecasts

%, avg	2019	2020	2021	Comment
GDP	0.2	-5.0	4.6	We now incorporate a large impact from the coronavirus outbreak, via weak global growth and commodity prices but also curtailed domestic consumption and production given the nationwide lockdown. This is extreme – the 2Q20 downturn would be the worst QoQ on record and would frame a deeper recession than during the GFC - but may not be a worst-case scenario. We are also concerned about anecdotal evidence that the economy was perhaps even weaker than we expected before the global pandemic outbreak; this is corroborated by the multi-decade low in (pre-COVID-19) business confidence.
HCE	1.0	-4.2	2.7	We were initially very sceptical about the likelihood that government would be able to negotiate a lower wage increase for public sector workers in FY20/21 but its reported announcement that it will implement a 0% increase at the beginning of the new fiscal year (presumably as it still negotiates the new wage increase with unions) is a strong signal of commitment to this saving. While crucial for fiscal sustainability, this will weigh on total HCE growth, along with a negative wealth effect and weak confidence as well as the impact of the pandemic on income and employment.
GFCF	-0.9	-3.9	5.2	The contraction in gross investment is now likely to be even deeper than we previously expected. Public sector infrastructure underspending is likely given delays that will be created by the announced lockdown, and further cuts are possible to help counteract the spending and revenue hits from the pandemic. Similarly, private sector fixed investment may incur some delays given the impact of the pandemic on profits and the short- to medium term economic outlook, and there might also be cuts given the slump in demand and uncertain short to medium term prospects.
R/$ (avg)	14.50	16.51	15.73	We are presumably getting closer to the peak currency weakness in response to the pandemic – while we expect this to be self-limiting and ultimately recover, the forecast risks are exceedingly high. Our rand forecasts incorporate the medium-term dollar weakness foreseen by our G10 strategist, Steve Barrow.
CPI (avg)	4.1	3.7	4.5	We foresee very little inflation pressure and at this stage the CPI impact of rand and oil price weakness negate each other. The more encouraging agricultural expectations now should help to contain food inflation, particularly if exports had to be redirected to the local market owing to the coronavirus outbreak constraining global trade. There is some risk that frost will damage crops, which we'll monitor carefully.
Repo (YE)	6.50	4.00	5.00	We see the risks as biased towards further monetary easing, though the SARB's choices aren't easy given the pronounced weakness of the rand amid an exceedingly weak economy. Near-term inflation will in our view not be a concern but the longer and deeper the rand's weakness, the more concerned the SARB will be about inflation pressure later on. The deeper the SARB cuts interest rates, the more likely is a partial reversal during the course of 2021.
10-year generic bond yield (YE)	9.00	9.8	9.4	Bonds are currently weakened not only by the poor fundamentals but also high, and rising, concern about a debt trap amid low liquidity and forced selling. We expect some retreat in yields in due course, but they will likely remain very elevated in absolute and relative terms; we've made some initial adjustments to our bond forecasts but they are still under review. The fiscal deficit is likely to reach 9.8% of GDP in FY20/21, narrowing to 8.7% in FY21/22 at current growth projections though it cannot be taken for granted that this is fundable, even amid a global search for yield once the coronavirus fades, unless investors believe that large reforms are underway. In the absence of such reforms, the poor fiscal and growth prognoses may ultimately force government to explore alternative funding sources amid the prevailing global crisis. Debt levels are expected to rise to above 70% in FY20/21 and above 80% by FY22/23.

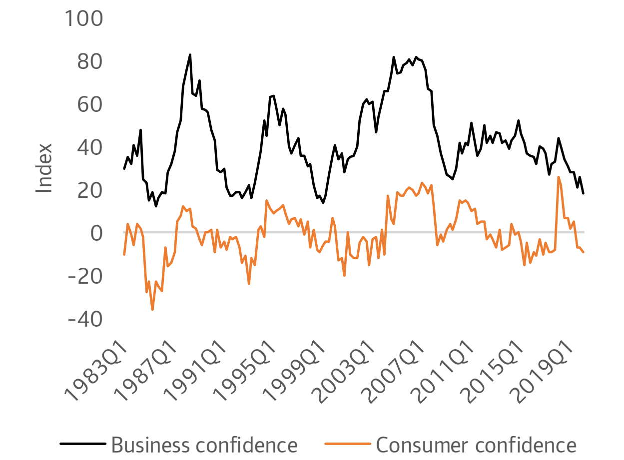
Source: Bloomberg, SARB, Standard Bank Research

Figure 2: GDP expected to plunge at unprecedented rate in 2Q20 – a double-digit (SAAR) contraction seems likely



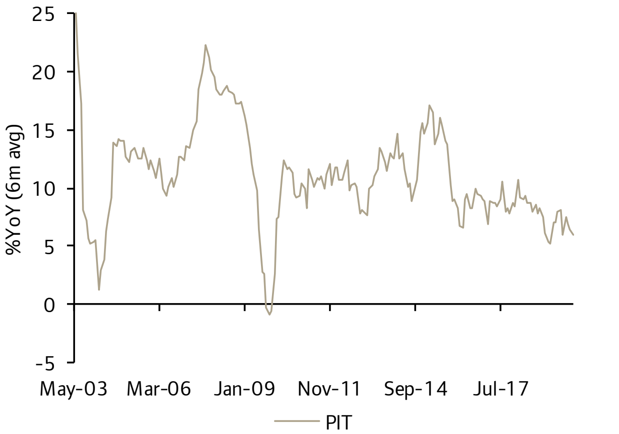
Source: SARB, Standard Bank Research

Figure 3: Business confidence was already exceedingly weak before the coronavirus pandemic's global outbreak



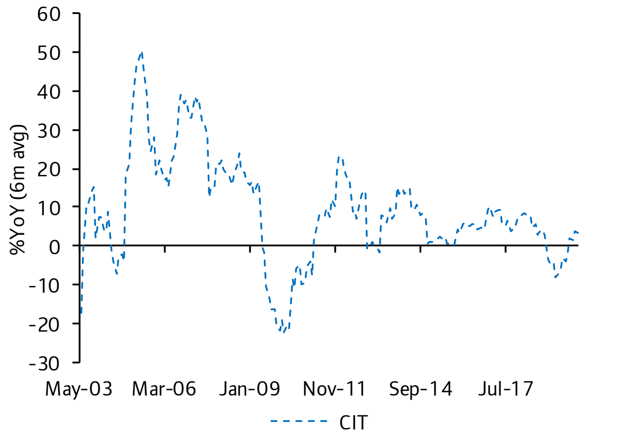
Source: BER

Figure 4: Personal income tax receipts won't have the gov't employment buffer of the GFC now – much bigger slump on the cards



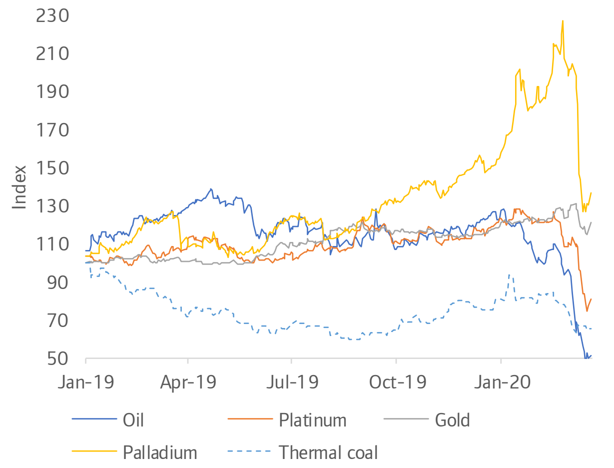
Source: Treasury, Standard Bank Research

Figure 5: Company income tax likely to contract sharply owing to weak demand and production disruptions…



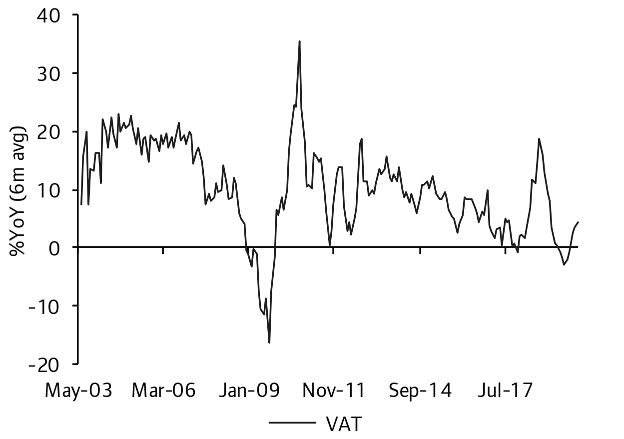
Source: Treasury, Standard Bank Research

Figure 6: …aggravated by plunging commodity prices



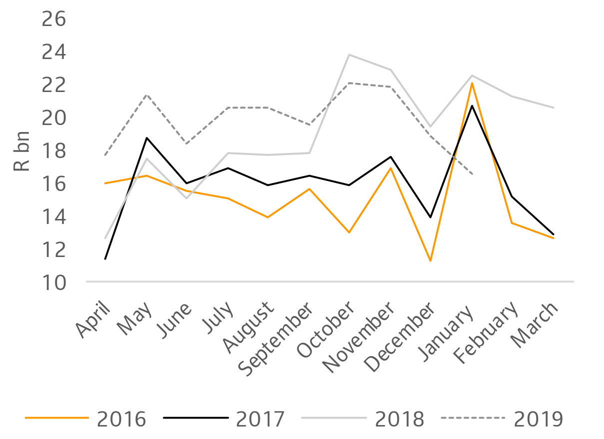
Source: Bloomberg, Standard Bank Research

Figure 7: VAT expected to be hit hard, despite the ongoing slowdown in overdue VAT refund payments; often new refund payments spike during sharp/unexpected slowdowns



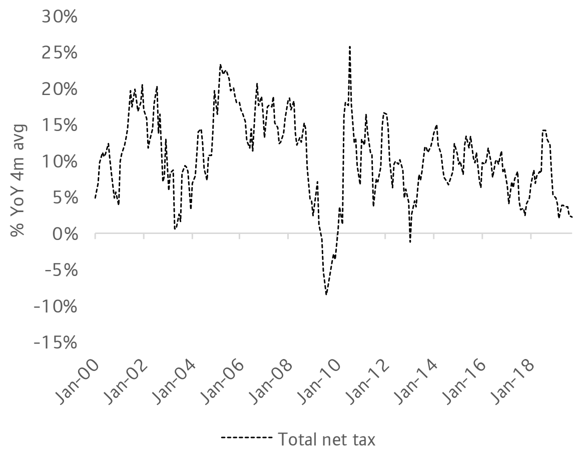
Source: Treasury, Standard Bank Research

Figure 8: Payment of overdue VAT refunds has slowed, as expected



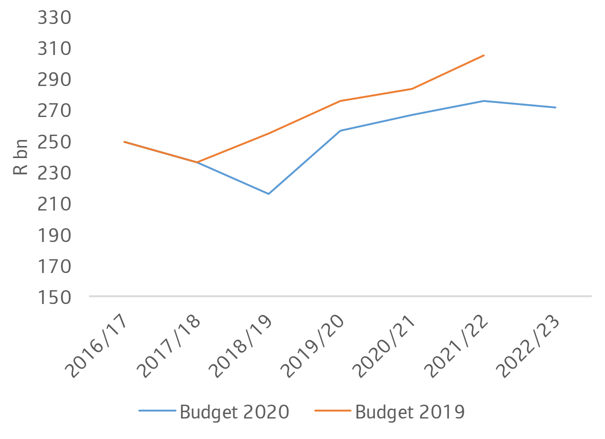
Source: Treasury, Standard Bank Research

Figure 9: Total tax revenues likely to fall more than during GFC



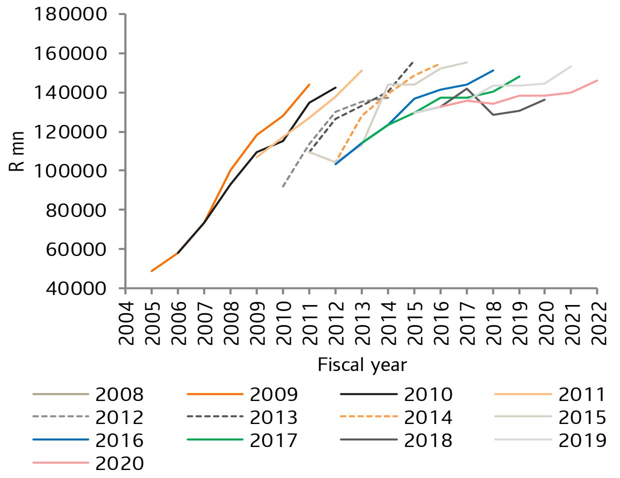
Source: Treasury, Standard Bank Research

Figure 10: Near-term infrastructure budgets were already cut quite significantly in Budget 2020…



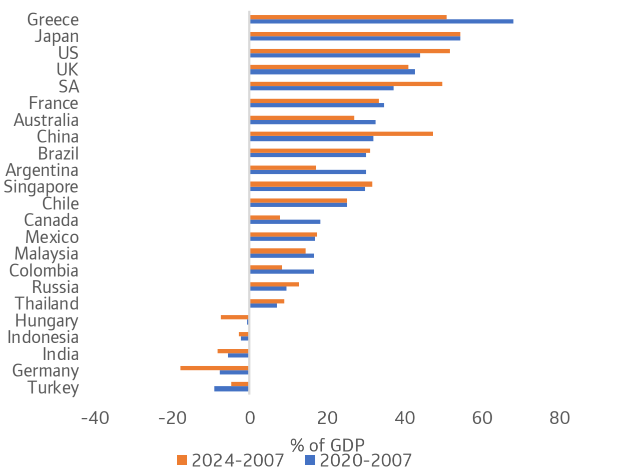
Source: Treasury, Standard Bank Research

Figure 11: …with new expected levels in line with recent actual spending (after underspending vs original budget), thus leaving no obvious underspending downside prior to the likely corona-related interruptions



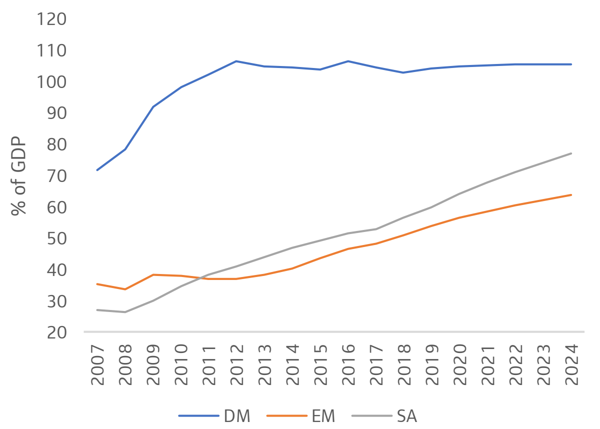
Source: Treasury, Standard Bank Research

Figure 12: Globally, countries haven't restored fiscal space after post-GFC expansion, entering the corona pandemic from a point of fiscal weakness



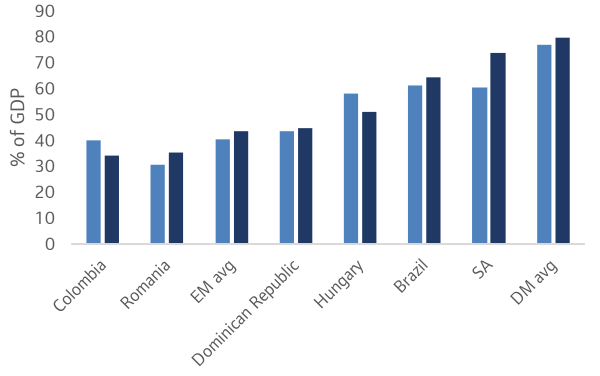
Source: IMF, Standard Bank Research

Figure 13: SA post-GFC fiscal slippage exceeded global norms



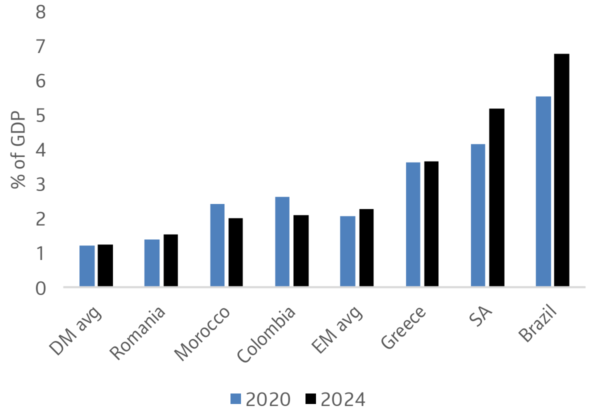
Source: IMF, Standard Bank Research

Figure 14: SA net government debt was getting high, and expected to rise further, vs peers, before the adverse impact of the pandemic



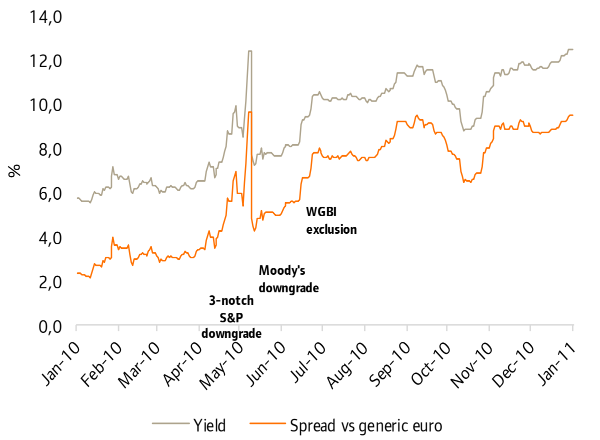
Source: IMF

Figure 15: Likewise, SA's debt servicing cost was getting relatively high in absolute and relative terms before the coronavirus pandemic



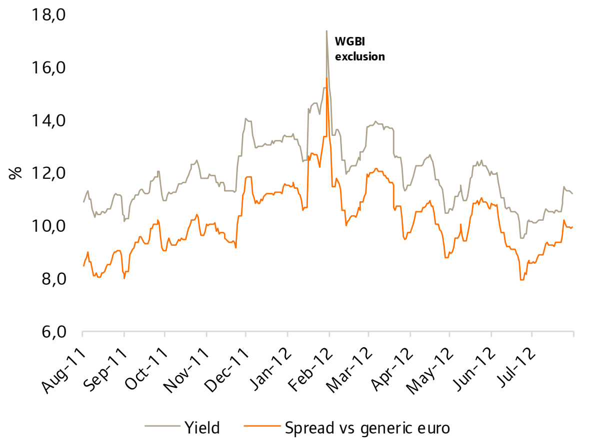
Source: IMF

Figure 16: Greek bond yields spiked when it lost its investment-grade status and following WGBI expulsion



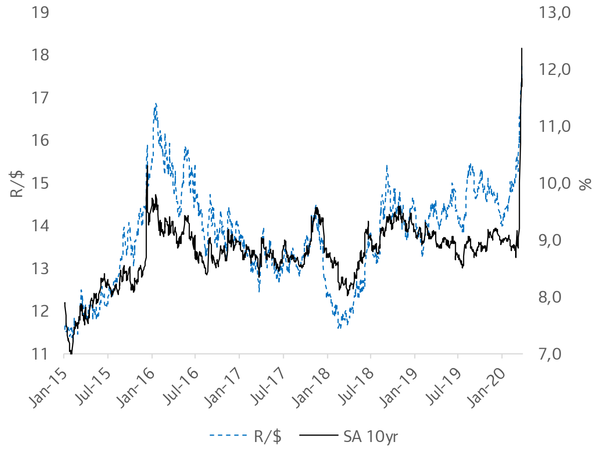
Source: Bloomberg, Standard Bank Research

Figure 17: Portuguese bonds spiked when expelled from WGBI



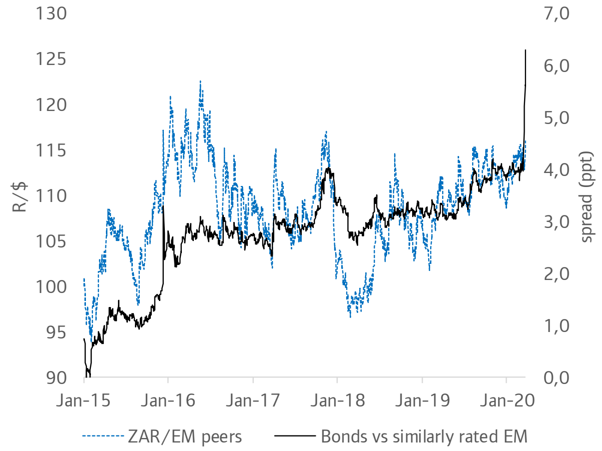
Source: Bloomberg, Standard Bank Research

Figure 18: Bonds and rand sharply weaker in absolute terms…



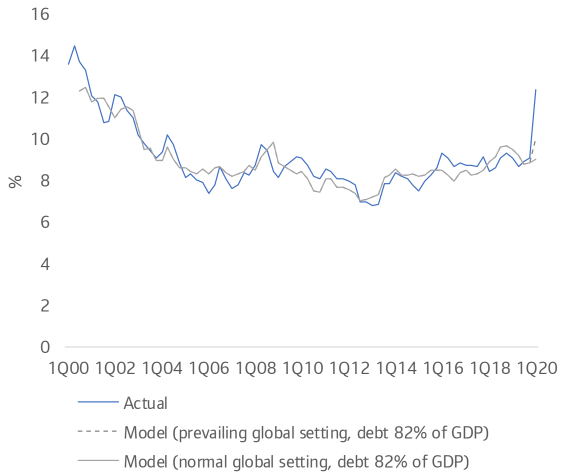
Source: Bloomberg, Standard Bank Research

Figure 19: …also weak vs peers – bonds in particular



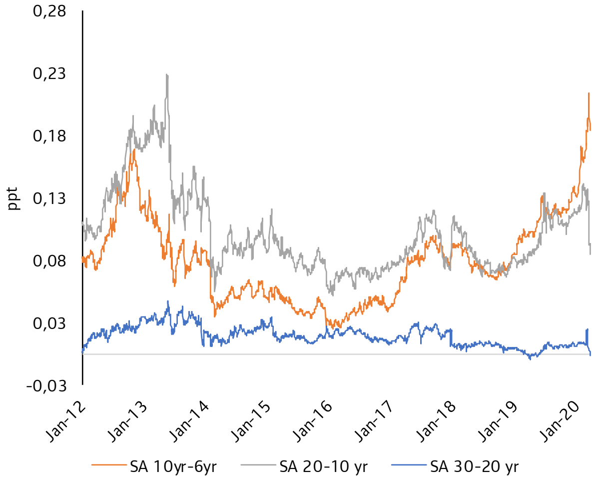
Source: Bloomberg, Standard Bank Research

Figure 20: Bonds undervalued even when weaker fiscal prognosis discounted



Source: Bloomberg, Standard Bank Research

Figure 21: Select adjusted yield spreads also exceedingly steep



Source: Bloomberg, Standard Bank Research

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