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in the moment

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COVID-19 growth slump hits the economy in the second quarter

Highlights

- Real gross domestic product (GDP) declined by more than expected by 51% in quarter-on-quarter seasonally-adjusted and annualised (q/q saar) terms in the second quarter of 2020 and was 17.1% weaker on a year-on-year (y/y) basis. GDP surprised to the downside, given the August 2020 Reuters Econometer median growth expectation of negative 44.5% q/q saar and our expectation of negative 50% q/q saar.
- GDP has declined for four consecutive quarters since the third quarter of 2019. However, with a resumption in economic activity, in line with an easing of the lockdown restrictions, expectations are for a bounce in growth in the third quarter of the year. The median growth expectation of the August 2020 Reuters Econometer is 18.6% for the third quarter of the year and is anticipated to decline to 6.1% in the final quarter of the year.
- According to the production stack-up of GDP growth, the largest detractors to activity included the manufacturing and trade sectors, which shaved off 10.8% and 10.5% respectively from the quarterly annualised growth figure. The agricultural sector was the only GDP division, which contributed to growth.
- Based on the expenditure stack-up of GDP growth, household spending detracted the most from overall economic activity, due to a collapse in spending on durables and semi-durables. A steep fall in construction works activity and machinery and equipment contributed to a collapse in fixed investment, while businesses continued to run down inventory levels in response to fragile demand.
- SA’s leading indicator for May 2020 began to reflect the worsening economic climate that spread throughout the second quarter of the year. Despite an initial rebound in growth anticipated for the third quarter of the year, soft sentiment indicators and electricity supply constraints are likely to curb the sustainability of the recovery.
- We expect growth to contract by 8.1% this year. We are pencilling in a shallow recovery of 2% in 2021, as an increase in the number of business closures, persistently higher levels of unemployment and ongoing challenges to electricity supply detract from the expected upturn. In our view, the level of economic activity is only likely to return to pre-COVID-19 levels by 2023/2024.

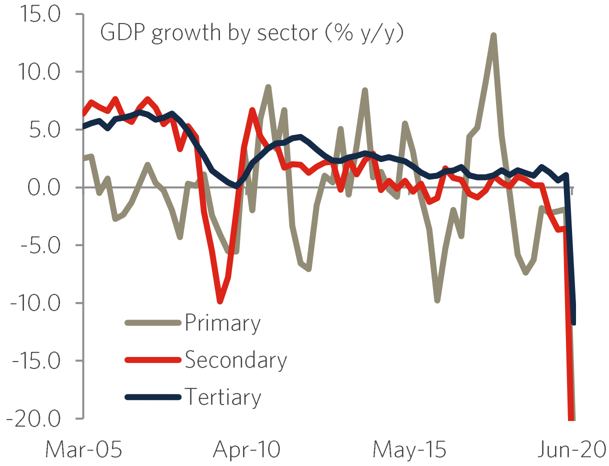
Steep quarterly growth contraction

Real GDP surprised the market consensus to the downside in the second quarter of 2020, as the effects of the pandemic and the associated lockdown measures ate into economic activity. Growth contracted by 51% q/q saar and was lower than the August 2020 Reuters Econometer median growth forecast of 44.5% q/q saar. Meanwhile, the first-quarter numbers were upwardly revised from a prior estimate of negative 2% q/q saar to negative 1.8% q/q saar, because of an upward revision in growth for the agricultural and trade sectors.

Growth in nine of the 10 economic sectors languished in negative territory for the second quarter of the year, with construction, mining, manufacturing and transport particularly hard hit. Meanwhile, activity in the agriculture sector posted encouraging growth of 15.1%, as guided by the Agricultural Business Chamber earlier in the year. The increase in activity came from an increase in production of field crops and horticultural and animal products.

GDP slipped 17.1% in the second quarter of 2020 y/y. On a disaggregated basis, the secondary sector (manufacturing, utilities and construction) experienced the largest fall in growth of 30.1% y/y, followed by a 23.7% y/y drop in the primary sector (agriculture and mining). Growth in the tertiary sector (largely services) contracted by a lesser 11.7% relative to a year ago (see chart 1).

Chart 1: Primary and secondary sectors underperformed in the first quarter



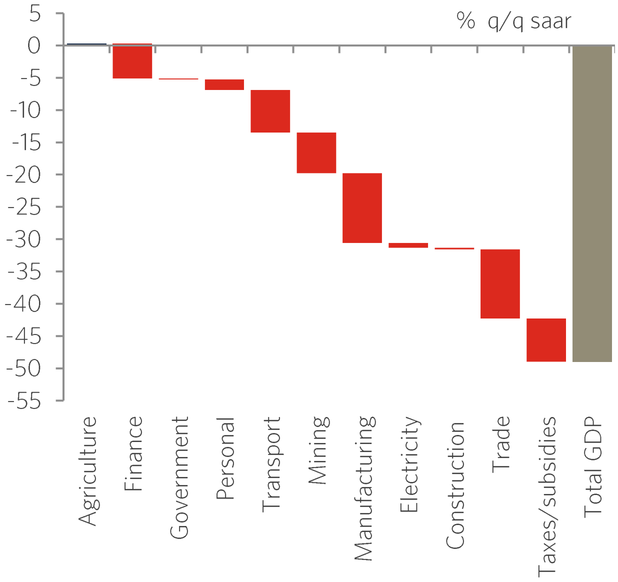
Source: Stats SA, Global Insight, Momentum Investments

Production-side real GDP

The manufacturing sector (accounting for 11% of overall economic activity) shaved 10.8% off the quarterly, annualised growth rate in the second quarter of the year, followed by a 10.5% drag from the trade sector (13% of overall economic activity), which includes retail, wholesale and motor trade as well as catering and accommodation. Stats SA noted the fallout was particularly severe for catering and accommodation establishments, which bore the brunt of stringent lockdown measures and curbed economic activity in this sector. Stats SA reported that all 10 manufacturing divisions experienced negative growth in the second quarter. The divisions, which pulled overall growth lower the most, included basic iron and steel, non-ferrous metal products, metal products and machinery, food and beverages as well as petroleum, chemical products, rubber and plastic products.

The mining and quarrying sector detracted 6% from the overall growth rate in the second quarter (see chart 2). Stats SA noted a fall in demand for mineral products, as lockdown restrictions were applied globally.
The production decline was most severe in the platinum group metals, gold, iron ore, chromium ore and coal divisions.

Chart 2: Manufacturing and trade were the largest detractors to growth in Q2 2020



Source: Stats SA, Global Insight, Momentum Investments

Poor economic growth conditions persisted in the construction industry, where activity contracted for the eighth consecutive quarter. The largest decreases in activity were in residential buildings, non-residential buildings and construction works (roads, bridges, etc.).

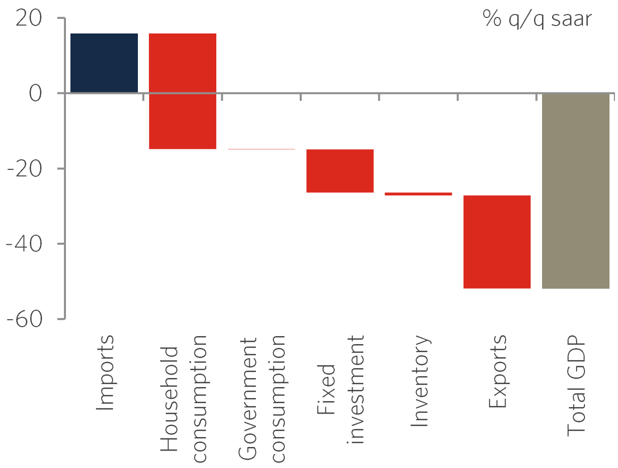
Growth in the largest sector in the economy, the government sector (accounting for 22% of economic activity), decreased by 0.6% q/q saar because of the retirements and resignations of employees in the public sector. While this trend is positive, the outsized public sector wage bill remains a considerable threat to fiscal consolidation.

Activity in the economy's second-largest growth contributor, finance (accounting for 21% of the economy), slowed by 28.9% q/q saar with a dip in activity reported for financial intermediation, insurance and pensions.

Expenditure-side GDP

The largest contributor to growth, based on the expenditure method, came from a reduction in imports, which bolstered growth in the second quarter of 2020 (see chart 3).

Chart 3: Contraction in household consumption and exports detracted the most from growth



Source: Stats SA, Global Insight, Momentum Investment

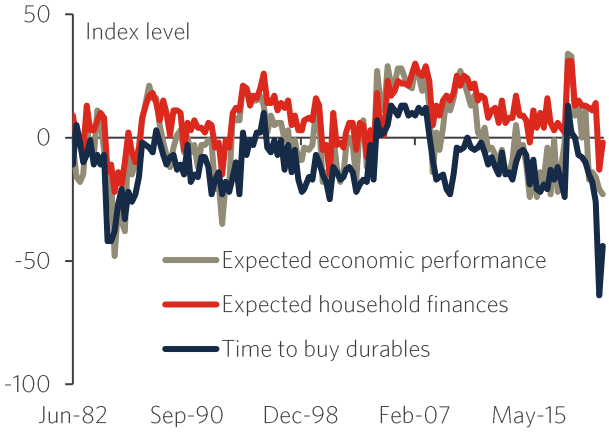
The reduction in household consumption detracted the most from growth, followed by exports and fixed investment.

As expected, on a disaggregated basis, household spending on durables and semi-durables was the most affected by lockdown restrictions. Spending on transport collapsed 11.7% q/q saar in the second quarter of the year, followed by an 8% drop in clothing spending and a 6.6% decline in spending on recreation. The alcohol and tobacco category had a drop in spending of 6.9% q/q saar for the second quarter of the year. The only categories, which escaped an outright contraction, included education (flat), housing and utilities (up 0.2% q/q saar) as well as communication (up 0.1% q/q saar), as more people worked from home.

We expect household consumption expenditure to remain under pressure, as pay cuts and retrenchments continue to curb spending. Work done by the University of Cape Town and the World Bank suggests that, while top-up grants alleviated poverty conditions for the bottom income-earning deciles, those in the seventh and eighth deciles experienced the sharpest contraction in incomes. The two-highest income-earning deciles were relatively sheltered.

The Bureau of Economic Research's (BER) Consumer Confidence Index showed a marginal recovery in sentiment from negative 33 points in the second quarter of the year to negative 23 points in the third quarter of the year. The survey responses were collected in the second and third week of August 2020, which would have captured the move to level two of lockdown, allowing for increased travel and leisure and the purchases of tobacco and alcohol products. On a disaggregated basis, the sub-index, looking at consumer expectations of economic conditions a year ahead, deteriorated, while consumers were less pessimistic on their expected financial conditions in a year's time (see chart 4). This held true across the various income groups surveyed from high to low. Despite a bounce off its lows, the index measuring the perceived time to buy durables remained deeply in negative territory, highlighting that consumers are not rushing out to purchases durable goods such as cars, furniture, electronic goods and appliances.

Chart 4: Consumers reluctant to spend on durables

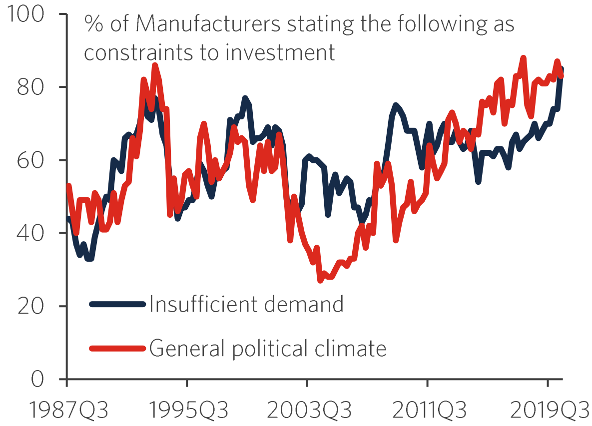


Source: BER, Momentum Investments, data up to Q3 2020

Fixed investment cut 11.5% from the overall growth figure for the second quarter of the year. The largest contractions in fixed investment were in the construction works and machinery and transport equipment components, but all other major sectors contributed to the contraction, including residential and non-residual construction.

Government aims to accelerate infrastructure building and has gazetted 50 bankable projects worth R340 billion. Another 26 have been identified for the next batch. Private sector fixed investment, however, remains hamstrung by elevated economic uncertainty and muted demand (see chart 5).

Chart 5: Policy uncertainty and insufficient demand holding back private investment



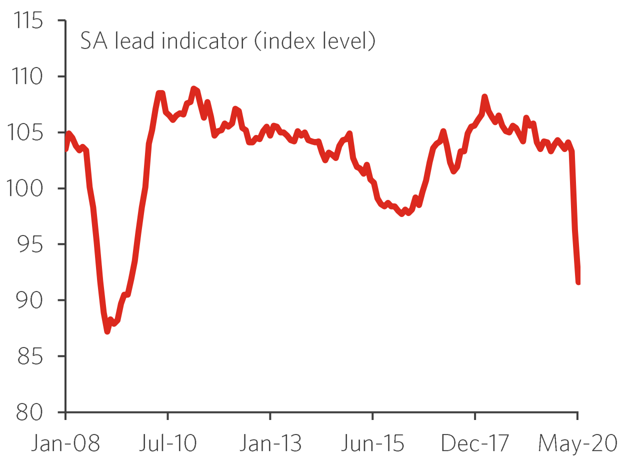
Source: BER, Momentum Investments, data up to Q2 2020

There was a R74 billion drawdown in inventories in the first quarter of the year, primarily in the mining and manufacturing sectors. Inventories are likely to remain volatile in the period ahead, as disruptions to the global supply chain continue to play out as a result of COVID-19 and in response to the damaging effect global lockdowns have had on global trade activity. The continued drawdown in inventory has been consistent with the inventory sub-index of the BER's Purchasing Managers' Index. The PMI inventories sub-component has printed below the 50-neutral mark since August 2019 and has averaged 40 points for the past year.

Muted confidence, bankruptcies, job losses and load shedding to stifle the recovery into 2021

The leading indicator continued its descent (see chart 6) in May 2020, in response to a rapidly deteriorated economic environment in the second quarter. On 23 March 2020, the president announced that the rise in COVID-19 cases in SA had necessitated a national lockdown. The country moved from a hard lockdown (level five restrictions) to level four from 1 May 2020. Lockdown regulations were subsequently eased to level three on 1 June 2020 with several restrictions being eased later in the month to allow for more businesses and services to operate. The country moved to alert level two on 18 August 2020.

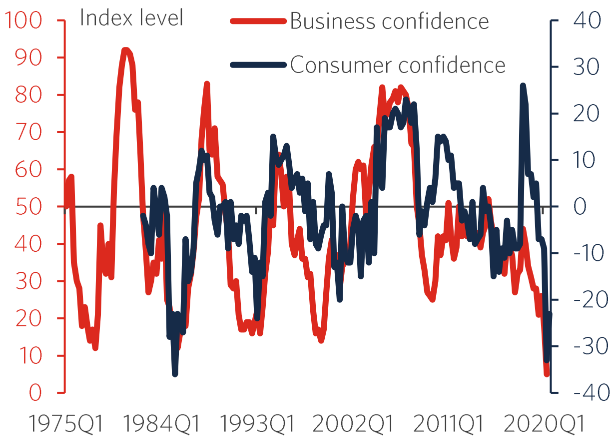
Chart 6: Plunge in SA's lead indicator



Source: Iress, Momentum Investments

The BER's Business Confidence Index for the second quarter crashed to an all-time low of five index points (see chart 7), signalling deep distress in the business sector.

Chart 7: Unsatisfactory sentiment



Source: BER, Momentum Investments, data up to Q3 2020

We expect growth to contract 8.1% this year, given that today's number was broadly in line with our own expectation for a 50% q/q saar contraction.
This compares to the August 2020 Reuters Econometer median expectation of negative 8% for 2020. Unlike the Reuters expectation for a 3.1% bounce back in growth in 2021, we see a shallower recovery of 2%. We remain cautious of a higher number of business closures and persistently higher levels of unemployment detracting from the upturn in growth envisaged next year.
Moreover, the increased incidence of load shedding poses a risk to economic activity.

In our view, the level of economic activity is only likely to return to pre-COVID-19 levels by 2023/2024.
This negative output gap (difference between actual and potential growth) will likely keep a lid on inflation in the near term.