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in the moment

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Business pulse: Sentiment plummets in Q2 2023

Highlights

- The FNB/BER Business Confidence Index (BCI) deteriorated for the fifth consecutive quarter to 27 in the second quarter of 2023. This marks the lowest confidence level since the third quarter of 2020.
- Weaker sentiment was expressed in three of the five surveyed industries, but the composite index was largely weighed down by new vehicle dealers (confidence declined by 21 points to 23).
- The Bureau for Economic Research (BER) notes that confidence levels would historically be somewhat higher at the prevailing economic output levels. Intensifying loadshedding is likely constraining confidence because it impacts all the industries, albeit to varying degrees.
- Manufacturers are becoming increasingly concerned about the political environment. A record high of 91% of manufacturers regard the political climate as a constraint to current business activity.
- On a quarter-on-quarter (q/q) basis, seasonally adjusted (sa) manufacturing output, reported by Statistics South Africa (Stats SA), was up by 1.4% and contributed positively to growth in the first quarter. However, the depressed confidence of manufacturers and the decline in the ABSA Purchasing Managers Index (PMI) suggest that activity in the manufacturing sector is, on average, likely to underperform.
- Quarterly growth in retail and wholesale trade sales was higher in the first quarter of 2023 but contracted on a year-on-year basis (y/y). The annual change is reflective of weaker demand due to lower consumer disposable income compared to last year. As such, y/y growth will likely remain weak or negative over the coming months.
- The steep decline (12.3% q/q, sa) in the agriculture industry in the first quarter of 2023 was unexpected. However, the Agricultural Business Chamber (Agbiz) estimates positive growth of around 3% in 2023 (estimate was prior to the first quarter contraction).
- Agbiz further indicates that government is exploring short-term and long-term measures to improve the agriculture operating environment. One of the short-term measures is the introduction of load curtailment in the industry.
- The first quarter Operation Vulindlela progress report notes that progress has been made since the previous report. One of the more notable areas of reform so far has been the surge in project registrations with Nersa. However, this will only start contributing to lower stages of loadshedding from 2024 onwards.
- According to the quarterly financial statistics published by Stats SA, capital expenditure by all industries surged to a five-year high in the fourth quarter of 2022. However, this has come off a low base.
- Higher costs incurred due to loadshedding have worsened expenditure-to-turnover ratios.
- Downtrodden business confidence points to a weakening in economic growth conditions ahead. Energy and logistic constraints, high political uncertainty and dampened demand inform our flat growth rate for this year. A

recovery in real wage growth and an alleviation in energy supply constraints should nevertheless drive a mild recovery into next year of 1%.

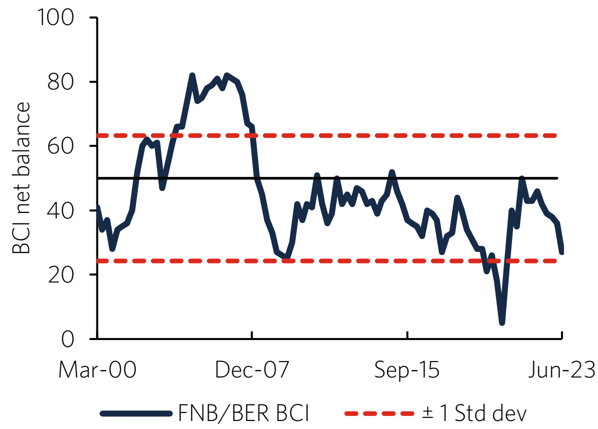
Business confidence down to lowest level since the third quarter of 2020

Business confidence, measured by the FNB/BER BCI, dropped sharply by nine points in the second quarter of 2023 to 27. This is the lowest confidence level since the third quarter of 2020 (the peak of the pandemic). Moreover, the index moved further below the 50-point neutral level as illustrated in chart 1 and was 2.9 standard deviations below the mean.

The BER notes that while lower output may have contributed to weaker sentiment, historically, confidence levels would have recorded somewhat higher at the prevailing economic output levels. This points to factors outside of business activity that are weighing on confidence, including persistent loadshedding. In the second quarter of 2023 (1 April to 6 June), the national hours of loadshedding were c.1 483. Other factors dampening sentiment as cited by survey respondents included the depreciating rand, concerns about SA's foreign policy stance, inflation and tighter monetary policy.

Sentiment in the second quarter was mainly driven down by new vehicle dealers and retailers. Confidence among new vehicle dealers dropped by 21 points to 23 and that of retailers was down by 14 points to 20. The survey was conducted between 10 May and 30 May 2023 and the repo rate was increased by 50 basis points on 25 May 2023. As such, the higher interest rate could explain the pessimism of new vehicle dealers. According to the BER, the decline in retail sector confidence reflects increased pressure on profitability and deteriorating business conditions. Wholesale traders also recorded a decline in sentiment from 40 down to 32.

Chart 1: BCI deteriorates for the fifth consecutive quarter



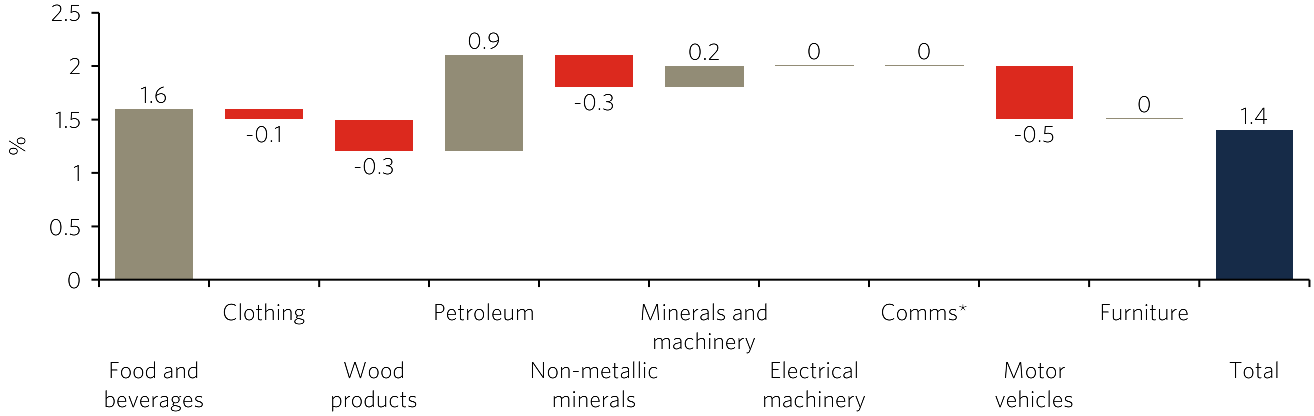
Source: BER, Global Insight, Momentum Investments

On the other hand, the confidence of manufacturers and building contractors was kept constant at 17 and 43, respectively. Despite manufacturer sentiment remaining the same, it is still the lowest across the five industries surveyed. The BER notes that less than two out of 10 respondents in the manufacturing sector were satisfied with the current business conditions.

Political landscape increasingly becoming a concern in the manufacturing sector

According to Stats SA, total manufacturing output in the first quarter of 2023 increased by 1.4% q/q, sa. The components that drove manufacturing output growth in the first quarter were food and beverages (7.3% q/q, sa resulting in a contribution of 1.6%) and petroleum, chemical products, rubber and plastic products (4.3% q/q, sa and contributing 0.9%) as illustrated in chart 2. While this industry was the largest contributor to first quarter GDP, the gains essentially reverse the contraction of 1.5% q/q, sa in the fourth quarter of 2022 meaning that manufacturing output in the first quarter of 2023 was largely at the same level as the third quarter of 2022.

Chart 2: Food and alcoholic beverages were the most significant contributor to manufacturing output in Q1 2023



Source: Global Insight, Stats SA, Momentum Investments
**Communication*

On a y/y basis, manufacturing production decreased by negative 3.6% in the first quarter of 2023 compared with first quarter of 2022.

The ABSA PMI averaged 50 (neutral level) in the first quarter of the year. The quarter started at 53 in January and slid to 48.1 in March. The index remained below the neutral level for the first two months of the second quarter (April: 49.8 and May: 49.2).

The sub-indices that decreased the most in May were inventories (51.1, down 7.7 points), expectations of business conditions in six months (43.7, down 7.3 points) and purchasing commitments (43.7, down 5.3 points). ABSA notes that the sharp decrease in expectations of near-term business conditions likely reflects concerns about the possibility of a grid collapse (low probability risk according to Eskom) and increasing concerns about geopolitical risks.

The PMI prices subindex was on average higher in the first quarter of 2023 (75.3) compared to the fourth quarter of 2022 (71.9). This indicates that manufacturers are incurring higher costs which are dampening growth in the sector.

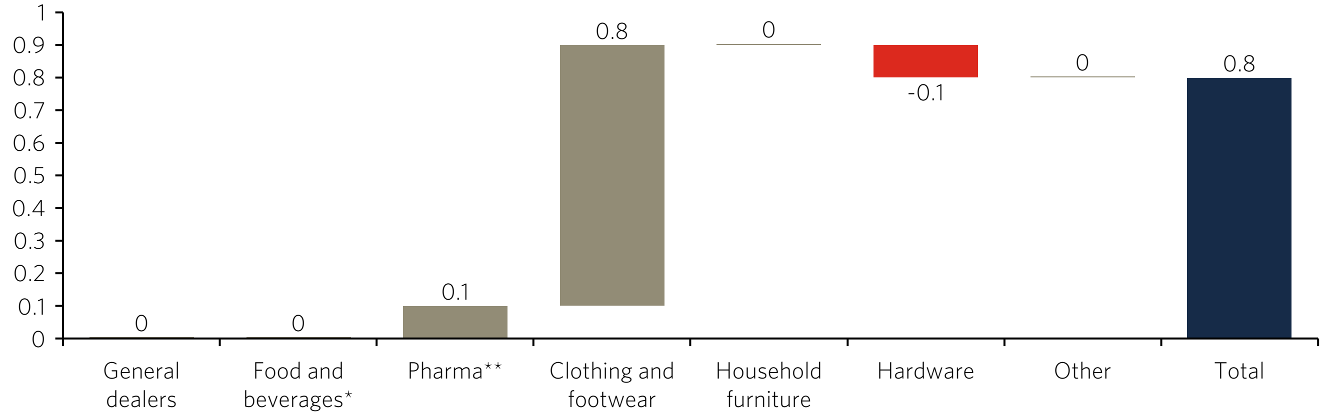
The BER's manufacturing survey reflects increasing political concerns with 91% of manufacturers indicating that the political environment is a constraint to current business activity. This is the highest percentage in surveyed history and is well above the long-term average of around 60%. Moreover, political concerns stretch out to the near term where 87% of manufacturers noted that the political climate will remain an investment constraint in the next 12 months. This may be influenced by the possibility of a coalition government post the 2024 elections and is aggravated by concerns around SA's foreign policy stance on Russia and the economic implications thereof.

The PMI was in contractionary territory for four consecutive months including the first two months of the second quarter. This, coupled with persistent pessimism expressed by manufacturers suggests that activity in the sector is, on average, likely to continue underperforming.

Downbeat sentiment extends to retailers and wholesalers

Retail statistics, reported by Stats SA, indicate that total retail sale volumes were up by 0.8% q/q, sa in the first quarter of 2023, contributing positively to first quarter GDP. This was predominately driven by the increase in clothing and footwear (see chart 3).

Chart 3: Clothing and footwear were the main contributor to Q1 2023 retail sales growth



Source: Global Insight, Stats SA, Momentum Investments
** Food, beverages and tobacco in specialised stores*
*** Pharmaceutical and medical goods, cosmetic and toiletries*

Similar to manufacturing output, retail trade sales grew on a q/q basis but contracted on a y/y basis in the first quarter of 2023. All retailer types, apart from clothing and footwear contracted in the first quarter of 2023 compared to the same period last year.

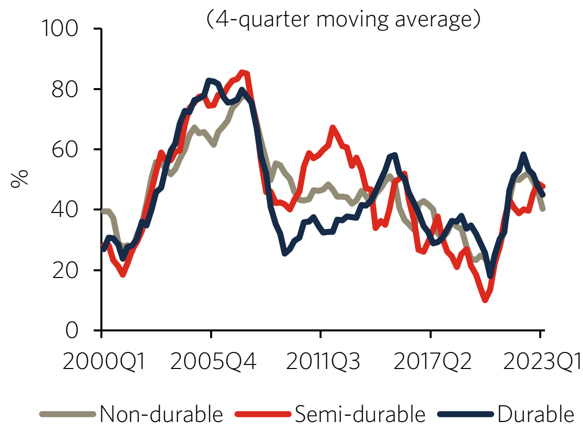
The hardware, paint and glass sector contracted the most by 5.7% y/y. This is the seventh consecutive contraction following the pandemic renovation boom. The second biggest contraction was sales of food and beverages in specialised stores (negative 4.8% y/y). Together with the decrease in the other retailers, total retail sales were down 1% y/y in the first quarter of 2023.

Similarly, wholesale trade sales were up by 0.1% q/q, sa in the first quarter but contracted on a y/y basis by 1.4%.

Wholesale and retailer confidence has plummeted since the second and third quarter of 2022, respectively. Wholesale confidence dipped to 37 in the fourth quarter of 2022, recovered slightly to 40 in the first quarter of 2023 and declined again to 32 in the second quarter (lowest level since the third quarter of 2020). Retail confidence was much lower at 20% in the second quarter of 2023.

As illustrated in chart 4, retailer confidence was weighed down by retailers in the non-durable space (correlates with the 4.8% y/y contraction in food and beverages retail sales). In one quarter, sentiment of traders in non-durable goods plummeted from 40% to 18%. This is reflective of sticky food and non-alcoholic beverages inflation which reduces demand for these goods.

Chart 4: Non-durable goods retailers are more pessimistic

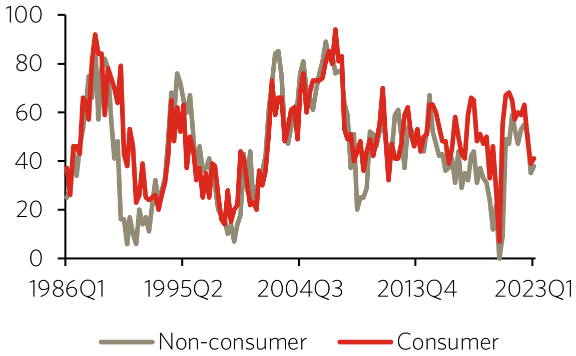


Source: BER, Momentum Investments

Wholesalers in the non-consumer goods sector were more pessimistic (38%) than wholesalers in the consumer goods sector (41%) in the first quarter. As seen in chart 5, this has been a consistent trend since 2015. According to the BER, the consumer goods sector includes agricultural raw materials and livestock; food, beverages and tobacco; textiles, clothing and footwear; and other household goods. Non-consumer goods comprise metals and metal ores; construction materials;

hardware; plumbing and supplies; other intermediate products; waste and scrap; and machinery and equipment.

Chart 5: Non-consumer goods wholesalers more pessimistic



Source: BER, Momentum Investments

Given the pessimism expressed by retailers and lower disposable incomes compared to last year, which has translated to lower demand, year-on-year retail trade sales will likely remain under pressure in the coming months. However, the expected gradual recovery in real wages will be supportive of household spending and ease pressures on retail trade sales.

Government explores measures to support the agriculture sector

The first quarter GDP report published by Stats SA provided a bleak outcome for the agriculture sector. On a quarter-on-quarter basis, the agriculture sector contracted significantly by 12.3%, sa. This steep decline was not expected and illustrates ongoing vulnerabilities in business activity.

According to Agbiz, government is working toward improving the operating environment for farmers and the solution of load curtailment has already been rolled out to farmers in certain provinces. However, load curtailment is not feasible for farmers who are connected to residential areas.

Some of the longer-term plans involve earmarking a portion of the Department of Agriculture's budget toward improving animal biosecurity to reduce the likelihood of animal diseases which affected the sector's performance in 2022. Addressing logistics constraints is also a key issue in this industry to allow for an efficient flow of goods.

Creating a more conducive environment for the agriculture industry is important for ensuring food security, containing food inflation and creating employment opportunities. Agbiz notes that international literature indicates that growth in the agriculture sector is two or three times more effective in reducing poverty than similar growth in other sectors of the economy.

Agbiz estimates that growth in the sector will be higher than in 2020 and 2021. This is largely due to higher estimated production in field crops and horticulture.

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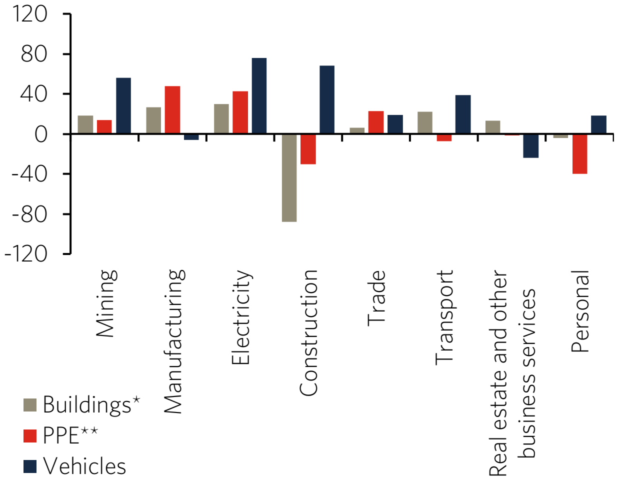
Capital expenditure growth surges to five-year high

According to the quarterly financial statistics published by Stats SA, capital expenditure by all industries (comprising a sample of enterprises in the formal non-agricultural business sector) increased by 15.5% q/q in the fourth quarter of 2022. This is the highest level since December 2017 (16.7% q/q). In the first quarter, the highest q/q growth was recorded in electricity, gas and water supply (42% q/q), followed by manufacturing (39.9% q/q), trade (19.5% q/q), and mining (16.3% q/q). The biggest contraction was in personal services (27.3% q/q) and construction (25.3% q/q).

Chart 6: Q4 2022 capital expenditure breakdown in the respective industries (%y/y)



Source: Global Insight, Stats SA, Momentum Investments
** Buildings, improvement, and construction works*
*** Plant, machinery, furniture, fittings and other equipment*
Real estate and personal defined in chart 7's footer

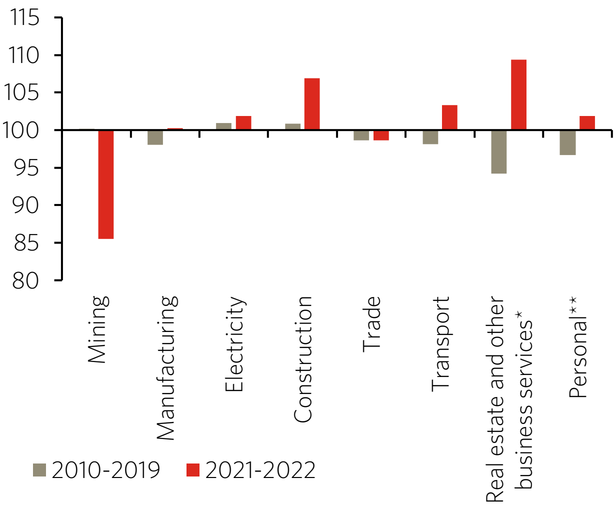
As illustrated in chart 6, capital expenditure in the electricity and mining sector was driven by vehicle purchases. In the manufacturing sector, the bulk of capital expenditure was in PPE. The lower investment in buildings and PPE in the construction sector outweighed growth in vehicle investment.

The SARB reported an increase of 1.3% q/q, sa in real gross fixed capital formation (GFCF) in the fourth quarter of 2022. This was attributable to private businesses (1.5% q/q, sa) and general government (2.5% q/q). GFCF by public corporations decreased by 2.3% q/q. On a y/y basis, GFCF grew by 4.7% in 2022 compared to 0.2% in 2021 marking the second positive outcome following five consecutive years of contraction. While 2022 recorded decent growth, the SARB notes that real GFCF is still 10.4% lower than in 2019 in level terms.

Industry turnover in the last quarter of 2022 decreased by 0.6% q/q following growth of 6.1% q/q in the third quarter of 2022. Lower turnover was recorded in five of the eight industries with the decrease in the electricity sector being the highest (negative 16.2% q/q). On the other hand, total expenditure increased by 1.4% q/q in the fourth quarter of 2022.

Chart 7 suggests that on average, industries are facing higher cost pressures following the pandemic compared to the period between the global financial crisis and the COVID-19 pandemic. This may likely be influenced by the impact of the supply chain bottlenecks during the pandemic and the rising costs incurred to mitigate the impact of loadshedding. Although supply chain bottlenecks have alleviated on a global scale, we will likely see high cost pressures affecting business margins as loadshedding persists. These pressures will lessen in the event of consistently lower levels of loadshedding.

Chart 7: Expenditure-to-turnover ratio highest for/lowest for (flesh out the heading a bit to make it more descriptive)



Source: Global Insight, Stats SA, Momentum Investments
**excluding financial intermediation and insurance*
***excluding government and educational institutions*

The dip in the mining sector is not because expenditure costs are coming down. Rather, it is reflective of a much higher turnover likely due to the commodity price boom following the COVID-19 pandemic.

The average expenditure incurred by industries in the real estate and other business services sector more than doubled over the last two years compared to the pre-pandemic average. This average is skewed by a spike in other expenditure during the third quarter of 2021.

Progress has been made on Operation Vulindlela, but sentiment remains depressed

Treasury recently released the 2023 first quarter progress report of Operation Vulindlela (a joint initiative of the Presidency and Treasury to accelerate the implementation of structural reforms). The programme focuses on five key areas, namely,

- Stabilise electricity supply
- Sustainable water supply
- Reducing costs of digital and telecommunications
- Competitive and efficient freight transport
- Visa regime to attract skills and tourism

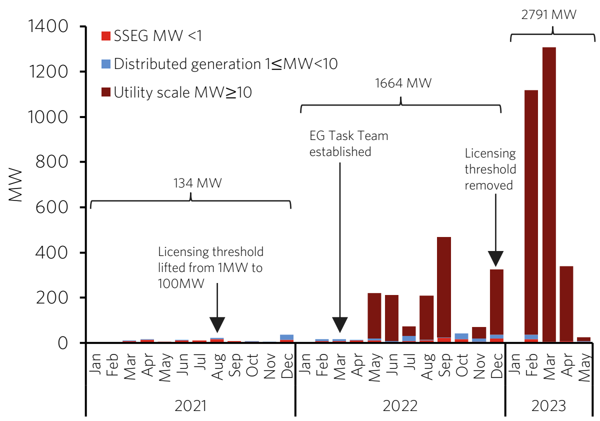
According to the report, there has been good progress since the fourth quarter report. The number of completed projects has increased from three to eleven, reforms that are facing challenges have decreased from nine to six and there have been milestones achieved on projects that are on track. The current progress dashboard indicates that 31% of the reforms have been completed (3% of which still require further work), 14% are assessed to be on track, 29% have not been started or are facing critical/significant challenges account and 26% are delayed but there is ongoing work. Despite progress made, public perception is still depressed and the Operation Vulindlela team attributes this to the nature of the reforms. The reforms are focused on unblocking regulatory constraints which won't have an immediate impact on the ground in terms of reduced loadshedding. However, addressing these regulatory challenges will have benefits in the medium- to long-term.

The report does, nonetheless, highlight the impact of the progress made thus far, particularly in the energy sector. The removal of the licencing requirement for generation projects of any size has amplified the number of projects registered with Nersa as illustrated in chart 8. The pipeline of projects has increased from around 4 000MW in March 2022 to just above 10 000MW.

The surge in project registrations has also been aided by the reduction of authorisation timeframes through streamlining processes. In the energy sector, the process that still has a long time frame is the budget quotation (BQ) process which takes four months (down from six months). As illustrated in chart 9, there is a large number of projects in the BQ stage. Following this stage, these projects can be registered which signals a further increase in Nersa registration in the months ahead.

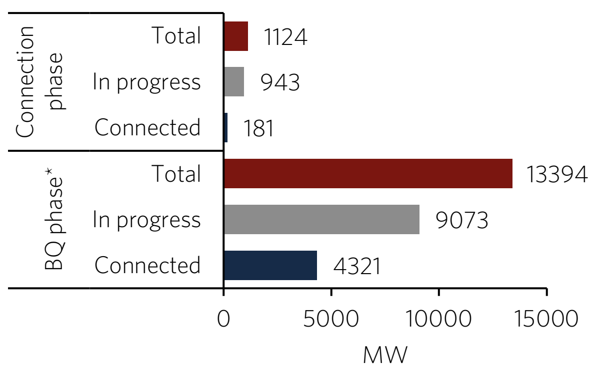
The Minister of Energy noted that it takes an average of 42 months from the proposal stage to when a project is completed and adds renewable energy to the grid. As such, we can expect meaningful relief in energy constraints from late 2024 onward.

Chart 8: Surge in Q1 2023 energy project registrations



Source: Operation Vulindlela, Momentum Investments

Chart 9: Size of projects in the BQ phase suggest further Nersa registrations ahead



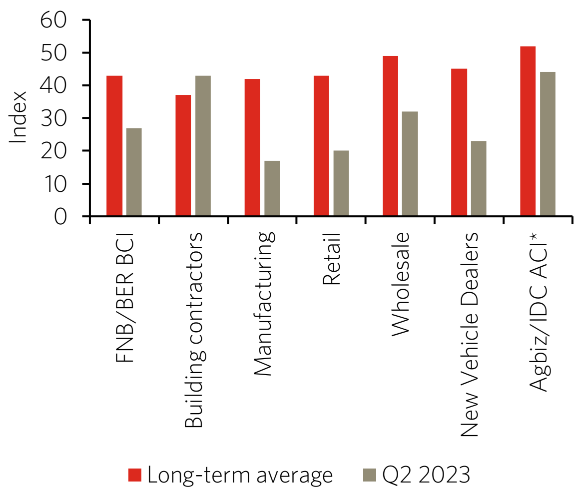
Source: Operation Vulindlela, Momentum Investments

Business operating conditions remain challenging

Although the economy grew at 0.4% y/y, sa in the first quarter of 2023, this positive outcome garnered some support from the low base created in the fourth quarter. The general business climate is still considered to be challenging by participants in different sectors of the economy, witnessed by a steep decline in business confidence from 36 to 27 in the second quarter of 2023.

Moreover, sentiment in all the sectors detailed in chart 10 is below the respective long-term averages which does not bode well for production, investment, employment opportunities, trade and ultimately economic growth.

Chart 10: Q2 2023 confidence levels below long-term averages



Source, BER, Agbiz, Momentum Investments
**Agbiz/IDC Agriculture Confidence Index (ACI) for Q1 2023*

However, government is committed to address the biggest constraint on growth (loadshedding) through Operation Vulindlela. The programme has, according to Treasury achieved great milestones thus far but the impact of this progress will only be seen in terms of reduced loadshedding from 2024 onwards. This is due to the long lead times before construction is completed.

In the meantime, loadshedding will persist and, according to Eskom, there is a risk of higher stages of loadshedding during the winter. Consequently, production and business activity will be hindered in the near term and companies will continue incurring higher costs due to investing in back up power and alternative sources of energy (reducing profitability and increasing the expenditure-to-turnover ratio).

Moreover, inefficiencies in the logistics network remain a constraint on business activity. To address this, government intends on setting up a National Logistics Crisis Committee (NLCC, similar to the National Energy Crisis Committee (NECOM)). The objective of the NLCC is to "oversee implementation of a Freight Logistics Roadmap which is being developed by Operation Vulindlela in coordination with the Department of Transport and the Department of Public Enterprises".

Given the energy and logistic constraints, high political uncertainty, and dampened demand, we expect a flat growth rate for this year (0%). The recovery in real wage growth and alleviation in energy supply constraints should nevertheless drive a mild recovery into next year of 1%.

In the June Economic Outlook note on SA, the Organisation for Economic Cooperation and Development (OECD) likewise estimates a weak growth of 0.3% in 2023 followed by a pickup to 1% and indicates that investments will be a crucial driver of growth. Furthermore, the report recommends that monetary policy needs to be resolute in anchoring inflation expectations, public spending needs to be improved to maintain fiscal consolidation, the tax system needs to be strengthened to reduce inequalities, and there needs to be a focus on boosting productivity to improve standards of living. According to the report, "boosting productivity involves improving transport (road, port and rail) infrastructure, providing more stable electricity generation, fostering the quality of telecommunication networks, broadening access to higher education, as well as improving the business environment more generally"