Herman
van Papendorp
Head of Investment
Research & Asset Allocation

in the
moment

Sanisha
Packirisamy
Economist

Economic outlook: 12 crucial questions about the world in 2023

Highlights

- Have we entered a new regime of greater macro and market volatility?
  The globe is facing higher levels of geo-economic fragmentation, reduced liquidity, a lower growth pattern in China, increased global conflict and higher inequality. This could lead to shorter and more erratic economic cycles, resulting in more volatile discount rates and lower equity valuations.
- What are the risks of over-tightening?
  Although an over-tightening in monetary policy raises the risk of negative growth outcomes sooner, the risk of under-tightening is seen to pose a bigger threat. Unhinged inflation expectations could force central banks to tighten policy even more, over a longer period, damaging growth and jobs.
- Will disinflation drive the narrative in 2023?
  A further easing in supply chain disruptions, favourable base effects in food and fuel and demand destruction are expected to drive inflation lower in 2023. A return to central bank targets could nonetheless take time given stickier services and wage inflation.
- When will the United States (US) dollar weaken?
  In the near term, disruptive geopolitics and higher growth and interest rate differentials should support the dollar. However, the dollar is likely to weaken in the second half of 2023 as interest rate and growth differentials begin to narrow. We project a further, but more gradual, depreciation in the dollar in the long term given its rich valuation as well as weaker current account and fiscal dynamics relative to that of the Eurozone.
- Where will interest rates plateau and when will financial markets see the big pivot to easier policy?
  In our view, central banks need to have clear sight of a sustained deceleration in underlying inflation and a reversal in tight labour market conditions for interest rate cuts to be considered. Market-implied policy rates point to a peak in the US federal (Fed) funds rate of 5% in the first half of next year. Market participants are pricing in a cut before the end of next year, after an expected pause.
- Will financial markets force fiscal consolidation?
  Financial markets are threatening to punish developed market (DM) governments that attempt to keep economies afloat with fiscal measures which raise upside risks to inflation. In addition, political cycles are likely to influence fiscal decisions heavier going forward, given an increasingly polarised electorate.
- Will we experience another emerging market (EM) debt crisis?
  Higher borrowing costs have intensified financial stress for vulnerable countries with a large share of foreign debt. However, middle income EMs with healthier macroeconomic fundamentals should fare better.

- **What could deliver a positive surprise in 2023?**
  A faster relaxation in COVID-19 regulations in China, a warmer winter in Europe that prevents energy rationing or stronger real wage growth for the US consumer can lift our base case view on global growth.
- **What if everything goes wrong at the same time?**
  Stickier inflation leading to additional interest rate tightening (relative to the baseline), a colder European winter that enforces more energy rationing, an extension of China's zero-COVID strategy, renewed Chinese property sector woes or an accelerated decoupling between the US and China could leave global growth at a mere 0.5% in 2023.
- **How will a global slowdown and local economic and political challenges affect South Africa's (SA) outlook?**
  Lower growth in SA's main trading partners will reduce demand for SA's exports, while slow reform in energy and logistics as well as mounting consumer headwinds will cap growth in domestic demand. Moreover, political uncertainty has leapt on the possibility of President Cyril Ramaphosa leaving his position. Question marks over SA's political outlook cast a dark shadow over investment and growth prospects.
- **When will interest rates peak in SA and when will the SA Reserve Bank (SARB) cut again?**
  The SARB is likely to hike rates further in the first quarter of 2023 to arrest the spread of broad-based inflation pressures. However, the likelihood of an improved global risk backdrop towards the end of 2023 could see the SARB reversing policy. The risk is nevertheless biased towards a tighter stance if higher political uncertainty drives the local currency weaker for a sustained period, leading to an uncomfortable jump in inflation expectations.
- **What are the risks associated with a greylisting event or further rating downgrades?**
  A potential greylisting and a consequent exiting of a greylisted status will depend on perceived action to address the Financial Action Task Force's (FATF) concerns. Recent political events threaten to derail the progress on the fight against corruption and raise concerns over the pace of structural reform in areas of the economy that promote growth and fiscal sustainability. As such, we see downside risks to SA's sovereign rating in the medium term.

Have we entered a new regime of greater macro and market volatility?

Despite the new Omicron variant of COVID-19 knocking at the door to the entrance of this year, people around the world were feeling surprisingly positive about the prospects for 2022. A poll conducted by Ipsos in 33 countries found that three quarters of respondents had more upbeat expectations for 2022 based on expectations of better global growth and lower volatility in financial markets. Many have, unfortunately, been negatively surprised at the way this year has unfolded. The world economy has faced a spate of ill-fated events, starting with Russia's war of aggression in Ukraine, a crippling energy crisis, higher inflation, tighter global financial conditions and strict lockdown measures in China.

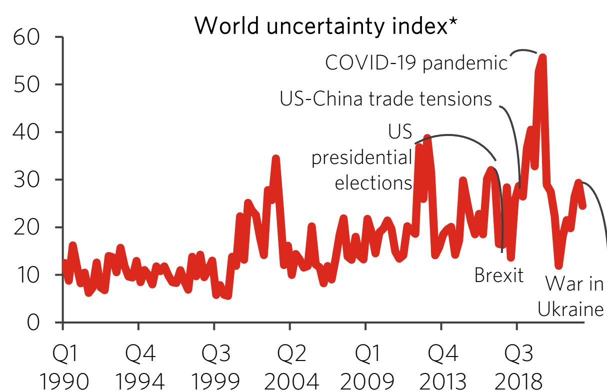
As the war in Ukraine enters its tenth month, Russia has refocused its war efforts to target civilian infrastructure. Although the Kremlin is beginning to feel pressure to show results in Ukraine after facing setbacks on the battlefield, financial markets deem the use of nuclear weapons as low. Nevertheless, in our view, this risk could rise should Russia face defeat in Ukraine.

Aside from the war in Ukraine, the global incidence of unrest has risen. But this could get worse before it gets better. In September this year, Verisk Maplecroft highlighted that from the 132 countries analysed, 62 were expected to see the risk of social unrest increasing in the next two quarters. This is unsurprising given the effect of sharply higher food and fuel costs on inequality, particularly across EMs where consumers typically spend a larger share of their wallet on such items.

The World Bank warns that we have shifted from an era of relative predictability to a world with more fragility. Previously, international co-operation was premised on a rules-based framework, resulting in lower inflation, lower interest rates and lower volatility. Greater uncertainty, higher volatility, geopolitical strife and more frequent climate-related disasters are

nevertheless gripping the global economy and darkening the outlook for growth.

Chart 1: Structurally higher uncertainty



Source: International Monetary Fund (IMF), Economist Intelligence Unit, Momentum Investments
**Units measured in thousands and data up to Q3 2022*

With five major shocks (including Britain's decision to leave the European Union (EU), Donald Trump's electoral victory in 2016, the start of a trade war between the US and China, the pandemic and more recently, the war in Ukraine roiling financial markets in the past six years, a landscape of greater geopolitical fragmentation and polarised politics are likely to power higher global uncertainty in the period ahead (see chart 1).

Wellington Management argues that under this new regime, central banks will, at times, struggle to find an appropriate balance between taming inflation and supporting growth. Consequently, we are likely to experience more frequent moves from one economic phase to another.

More regular economic and political shocks are likely to throw economies off course more easily unless a greater level of resilience is instilled at a macroeconomic level. While random and exogenous events can overshadow the impact of fundamental factors, a focus on long-term structural trends can help to reduce reliance on timing shorter-term cycles and shorter-term economic and market forecasts, which are likely to span a wider range going forward.

What are the risks of over-tightening?

The impact of the war in Ukraine, persistent inflation, soaring cost of living pressures, an acute energy crisis in Europe and an unexpected slowdown in China have impaired growth. With policy homogeneity having increased across the globe this year, investors are concerned that a simultaneous tightening in monetary policy will compound growth woes. Although we have experienced the fastest pace of interest rate hikes in decades, the World Bank shows that interest rates, particularly in inflation-adjusted (real) terms remain negative in aggregate and are significantly lower now relative to prior global recessions in post-war history.

With rising price pressures posing the most immediate threat to real disposable incomes, central banks have narrowed their focus on restoring price stability, even as fears mount over slowing global growth. While the IMF acknowledges the potential risks associated with an over-tightening in monetary policy, to the extent that policymakers are forced to reverse hikes sooner than anticipated in a perceived policy error, it warns that the risk of under-tightening is a larger concern. Allowing inflation to run hotter for longer could derail inflation expectations and embed persistent price pressures. Central bank credibility would not only be negatively affected, but a deeper cost-of-living crisis would force central banks to tighten by more, at a later date, compounding negative growth and employment outcomes.

Prospects for growth in 2023 have dimmed considerably. At the start of this year, the consensus expected DMs to grow at 2.4% in 2023. However, this projection has faded to 0.7%. Similarly, financial markets were looking forward to growth of 4.8% in EMs next year. But these forecasts have since slipped to 4.3%. This is in spite of a better expected outcome for China in 2023.

Although these revisions appear large, the World Bank notes that market revisions to growth in the year preceding a recession were worse during the global financial crisis (GFC) and the COVID-19 pandemic. In the case of the former episode, expected global growth

experienced a downgrade around 5.5% in the year running up to the recession. Meanwhile, downward revisions to expected global growth in the year preceding the pandemic amounted to more than 7%. In this context, the adjustment to growth forecasts this time around does not appear as severe. As such, we see the risk of a global downturn as being higher than an outright global recession.

The World Bank makes a clear distinction between global downturns and global recessions. In the case of the past three global downturns in post-war history (namely 1998, 2001 and 2012), growth in global gross domestic product (GDP) on a per capita basis averaged more than 1.2%. On the other hand, per capita GDP declined by an average of 2% during the five post-war recessions during 1975, 1982, 1991, 2009 and 2020. A contraction in real GDP per capita impacts standards of living and has significant socio-economic repercussions, making the distinction between a downturn and a recession important.

The risk of a global recession can, however, not be definitively ruled out at this stage. With the IMF predicting that growth in more than a third of economies worldwide will contract either this year or next (up from 5% at the start of 2022), the World Bank warns that only a small shock is required to knock the global economy into a deeper slump.

Indicators such as global growth, manufacturing new export orders, the global purchasing managers' index and global equity prices have followed the same path as prior global recessions. Consumer sentiment has however fallen more sharply relative to past cycles on the back of a collapse in growth in real disposable income of negative 3.5% for the global economy, due to rising living costs.

Depressed sentiment has raised recessionary risks (see chart 2). At the end of 2021, the Bloomberg consensus forecasted the recession risk for the US economy in the next year at 15%. However, this probability rocketed to 60% in November 2022. Similarly, the consensus pitched the probability of a recession in the United Kingdom (UK) and Germany at around 20% at the end of 2021, but these forecasts have since jumped to between 80% and 90%.

Chart 2: Markets have grown more concerned about recession

Source: Bloomberg, Momentum Investments

The outcome for the US economy plays an important role in determining the recession probability for the global economy. The World Bank notes that on an unconditional basis, the probability of a global downturn or recession is between 10% and 15%. However, if the US economy slips into recession, the risks of a global recession or downturn are higher at around 70% and 85%, respectively.

In our view, solid fundamentals could prevent a deep and protracted recession in the US economy despite our forecast of a marginally negative growth rate for 2023 of negative 0.1%. Firstly, household wealth (still close to 780% of disposable income) and savings remain supportive of household spending. Secondly, unemployment rates remain close to multi-decade lows with the US labour force participation rate close to 80% if the age group older than 54 years is excluded. Thirdly, banks' capital buffers are higher than in the period leading up to the GFC, leaving the US economy with a higher level of financial stability this time around. Fourthly, central banks have acquired a higher level of credibility since the 1970s when the world hit a stagflationary bump in the road.

And finally, even though the US housing market is showing signs of distress, the dip experienced so far has not been as severe as that during the GFC.

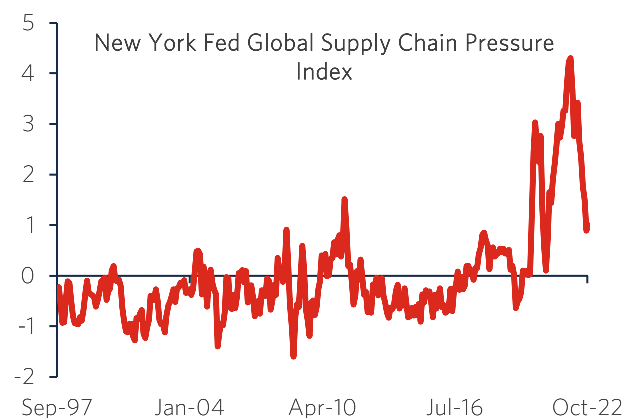
Economic troubles are, nevertheless, bubbling in Europe, leaving growth prospects for 2023 weaker than in the US. The rise in cost of living due to energy in 2022 (as a share of average household consumption) is as high as 12% for Italy and 10% for the UK. As such, we expect tighter financial conditions and a high cost of living to leave growth at negative 0.5% for the Eurozone and negative 0.7% for the UK in 2023.

The political landscape in Europe complicates growth projections in the medium term. Right-leaning parties account for a significant share of the vote and are gaining prominence in some countries, more notably Italy. In our opinion, rising political fragmentation could derail efforts of improving co-operation across the EU and furthering the region's policy agenda.

Will disinflation drive the narrative in 2023?

While inflation dominated the headlines in 2022, convincing signs of supply-side inflation receding could result in disinflation driving the narrative in 2023. The New York Fed President John Williams recently remarked that the outer layer of the inflation onion has shown signs of relief. Supply chain bottlenecks have been easing consistently. Supplier delivery times have shortened drastically, while the New York Fed Global Supply Chain Pressure Index has tumbled (see chart 3).

Chart 3: Consistent easing in global supply chain bottlenecks



Source: Bloomberg, Momentum Investments

While Williams notes that core goods inflation, which makes up the middle layer of the onion, remains high, there are signs of this reversing. Moreover, continued dollar strength has reined in inflation on imported goods.

Williams warns that the innermost layer of the onion, underlying inflation, is where the most attention needs to be paid. Stickiness in inflation in this area of the consumer basket can result in a slower pullback to the Fed's inflation target of 2%.

That said, forward-looking signs are painting an encouraging picture. Growth in M2 money supply has dropped from over 25% 18 months ago to 0%. Given its typical 18-month lag with inflation, price pressures should ease significantly in the coming quarters. Indicators such as the Zillow Observed Rent Index point to a softening in rental inflation, while fewer small businesses are planning to raise selling prices. Overstocked retailers in the US will also find it difficult to pass on higher costs in an environment of slowing excess demand.

Similarly, few businesses in the Eurozone are flagging a rise in input costs and selling prices, pointing to fading corporate pricing power. Moreover, inflation surprises have narrowed in both DMs and EMs, while longer-dated inflation expectations have come off the boil in the US and Eurozone.

While the Bloomberg consensus suggests that we have passed the peak in inflation, globally, inflation is likely to remain above target in the next year. The median consensus shifted its expectation for headline inflation in DMs for next year from 2.1% at the end of 2021 to 4.9% in October 2022. Similarly, the market's projection for headline inflation in EMs rose from 3.6% to 5.3% in the same period.

When will the US dollar weaken?

While 2022 has been a shocking place for investors, with no place to hide, the US dollar and a number of key commodities have delivered exceptional returns. Despite a fall late in the year, prompted by investors' expectations for a slower speed of interest rate tightening by the Fed, the dollar's strength for the year has been even more pronounced when comparing it to the poor performance in equities, bonds, real estate and cryptocurrencies (see chart 4).

Chart 4: The global economy has creaked under the strain of a strong dollar

Source: Bloomberg, Momentum Investments

Geopolitical conflict, which has sucker-punched the global economy, has driven investors into safe-haven investments, including the US dollar.

Research by the European Central Bank further attributes a firmer US dollar to better relative macroeconomic outcomes in the US and a higher interest rate differential with the Eurozone. While these factors can continue to drive dollar strength in the interim, we expect narrower interest rate differentials from the second half of 2023 to drive dollar weakness. As interest rates decline in the US economy, investors are likely to transfer money out of the US and into other countries that offer a higher interest rate. These capital flow adjustments are likely to lead to a weakening in the US dollar against the currencies of higher-yielding countries.

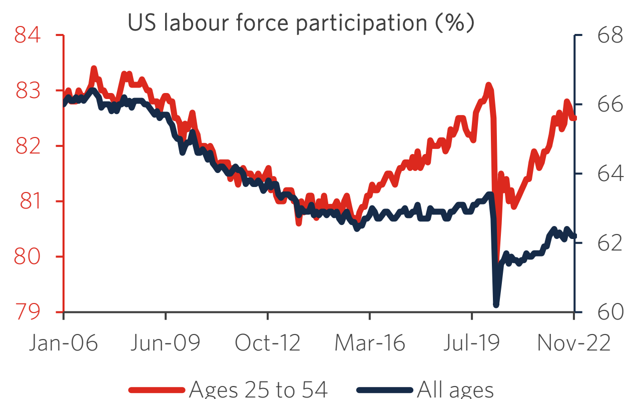
Market-implied policy rates expect the US Fed to wrap up its interest rate hiking cycle in the first half of 2023, peaking at 5%. The first cut has been pencilled in before the end of next year, following a pause after the last hike.

The dollar is expected to follow a depreciating path over the medium to longer term, but the rate of depreciation is likely to slow beyond the next year. US government budget and current account deficit projections look unfavourable relative to the Eurozone in the medium to longer term, while a rich valuation on a purchasing power parity calculation further suggests some retracement in the dollar.

Where will interest rates plateau and when will markets see the big pivot to easier policy?

Central banks' focus up until now has been to tame inflation even as recession risks loom. While reaching a peak in global inflation is a necessary condition and may be enough for central banks to reach a peak in hawkishness, it is not seen as sufficient for an actual pivot towards an easing in monetary policy. In particular, we believe that central banks need to see a clear deceleration in underlying inflation or a reversal in tight labour markets (see chart 5).

Chart 5: US jobs market still tight



Source: Bloomberg, Momentum Investments

Although hiring is slowing (non-farm payrolls slowed to a three-month average of 290 000 in October 2022), MRB Partners shows that payrolls tend to average closer to 95 000 during interest rate cuts. Moreover, although the headline level of labour force participation languishes at 62%, after excluding the age group above 54 years old, participation rates jump closer to 83%. This is indicative of continued strength in the US labour market, which underpins higher wage growth.

Will financial markets force fiscal consolidation?

Bill Clinton's political adviser once alluded to the strength of the bond market and said "I used to think that if there was reincarnation, I wanted to come back as the President or the Pope, or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody".

Fixed income markets in the UK punished the former administration, led by Liz Truss, at the end of the third quarter of 2022, when she delivered budget proposals that markets expected would only spur inflation and necessitate even more tightening in monetary policy.

While previously, DM governments could enact fiscal stimulus without worrying too much about higher inflation, we have now shifted to an era with more explicit policy trade-offs. While the previous UK administration was merely applying the old framework, financial market participants forced more fiscal responsibility in a time of higher inflation and tighter monetary policy.

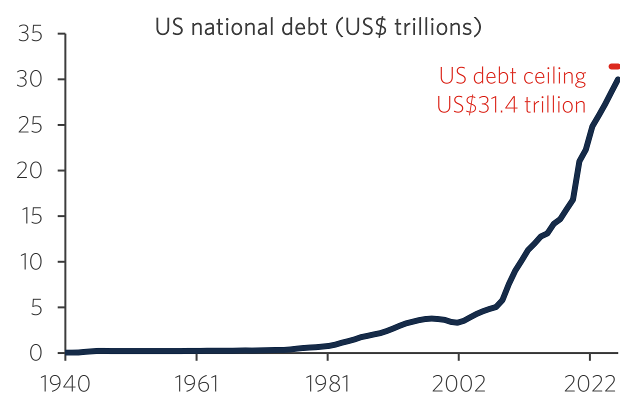
The IMF warns that now is the time to rebuild fiscal buffers. Fiscal policy must work in concert with monetary policy, otherwise, the IMF warns, the fight to douse inflation will only be prolonged. The World Bank points out that the fraction of countries tightening fiscal policies next year is expected to reach its highest level since the early 1990s. As such, this could amplify the negative effects of tighter monetary policy on growth.

Nonetheless, we believe that in a slower growth environment, with higher levels of social unrest, governments around the world will be tempted to lean on fiscal policies to alleviate growth troubles. Moreover, electoral cycles are expected to increasingly influence fiscal decisions in a more politically polarised world.

Research conducted by Colombia University has proven that income inequality (which can spur social unrest) is highly correlated to periods of political polarisation, leaving governments under pressure to address rising social demands.

Over in the US, analysts warn that reaching the debt ceiling could land up being used as a political tool as it was in 2011, resulting in a sovereign downgrade by Standard and Poor Global Ratings (see chart 6). Vox warns that the outcome of the likely standoff could potentially end in a further weakening in parts of government that have already been underfunded for a decade, including education, transport, water resources and international affairs.

Chart 6: Debt ceiling debacle likely to resurface



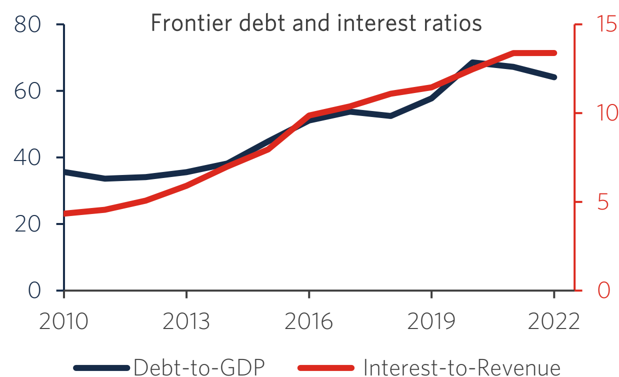
Source: Bloomberg, Momentum Investments

Will we experience another EM debt crisis?

EMs have experienced the fastest rise in debt in the past decade than they have in the past 50 years. In particular, the median frontier debt ratio and debt-servicing burden has nearly doubled since 2010 (see

chart 7). Moreover, higher global borrowing costs have intensified financial stress for vulnerable countries with a large share of foreign-denominated debt.

Chart 7: Rise in debt vulnerability in frontier markets



Source: IMF, Momentum Investments

A number of heavily indebted lower-income countries were already facing distressing conditions before the pandemic struck. Low tourism, a strengthening dollar, a reversal in capital flows and high inflation have spelt even more trouble for these nations.

Meanwhile, the backdrop of weaker global growth is likely to increase EM vulnerability. A sharp slowdown in the US or Eurozone or softer-than-expected growth in China could trigger acute financial stress in emerging and developing countries.

While we believe that larger middle-income countries are economically and fiscally fit to weather this storm, poorer and more-economically exposed nations will likely find it difficult to avoid fiscal and debt distress. As such, more dominoes could fall in this narrower composite.

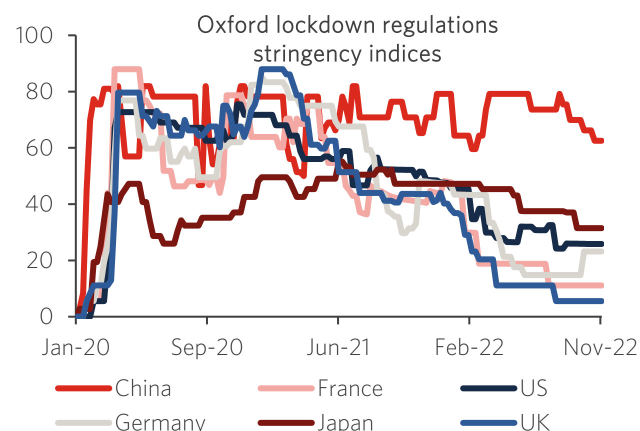
What could deliver a positive surprise in 2023?

Although global inflation picked up sharply after the first quarter of 2021, it rose more modestly in Asia due to healthy food harvests and fuel subsidies. Inflation in Asia, however, started to climb and broaden in 2022 after Russia's invasion of Ukraine. Nevertheless, weak domestic demand has kept a lid on core inflation. As such, inflation fears have not forced the same degree of monetary tightening in a number of Asian economies, most notably China and Japan. This has allowed for more headroom for growth-oriented policies in the region. Further growth in tourism and supply chain diversification will boost growth in a number of Asian economies in the coming quarters.

Meanwhile, a gradual loosening of zero-COVID policies, an investment in climate transition and a frontloading of infrastructure projects are likely to fuel a recovery in China in 2023. This recovery is expected to follow one of the country's worst projected growth performances, in decades, for 2022.

While we acknowledge that property market woes may spill negatively into economic growth, leaving the expected growth figure for 2023 short of Beijing's 5.5% target, a faster relaxation in stringent lockdown regulations in China could result in a rebound in downtrodden consumer confidence (see chart 8). As such, a revival in household spending and tourism could deliver an upside risk to the outlook for the global economy in 2023.

Chart 8: Draconian zero-COVID strategy in China



Source: Bloomberg, Momentum Investments

Analysts suggest that Russia picked the worst year for gas blackmail. Not only has Europe experienced a record-warm season so far, but the region has had unprecedented late gas injections. Moreover, liquified natural gas supplies hit a record high and disappointing

demand in China has lowered global demand for energy.

With Europe's gas storage level reaching the highest level in over a decade, supplies may just be sufficient to meet demand, lowering the need for caps on energy demand and leading to a potentially better outcome on European growth.

The US economy could likewise deliver a positive growth surprise in 2024. If real disposable incomes recover more strongly than anticipated, owing to higher nominal wages, lower inflation and strong jobs growth, a more buoyant US growth wave could lift all economic ships next year.

A better growth scenario could also result from a quicker turnaround in global inflation, a lower peak in interest rates and a shallower bottom in growth.

What if everything goes wrong at the same time?

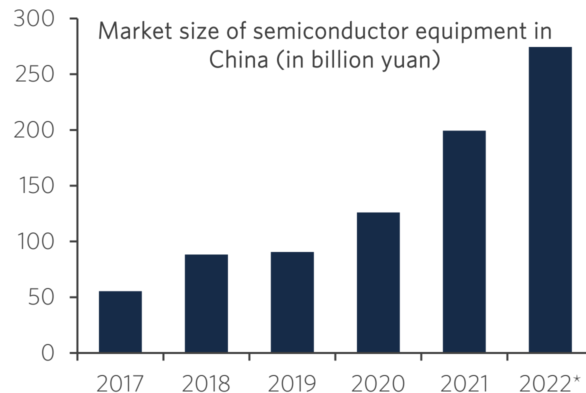
One can easily think of ways in which the situation could get worse. A higher magnitude and longer duration of interest rate tightening could push the US economy into a more painful slump, dragging growth in all economies lower.

A colder-than-expected winter in Europe could raise the urgency of Europe's energy crisis, enforcing caps on usage and lowering demand.

Protests erupted across China in November 2022, against the country's lockdown disruptions. A rise in COVID-19 cases and still-low vacancy rates among the elderly have nevertheless encouraged authorities to maintain restrictions on mobility. Onerous regulations could set a gloomier scene for Chinese growth and consequently commodity prices in 2023, worsening the outlook for EMs that are highly reliant on trade.

Moreover, geoeconomic fragmentation remains a risk for Asia. Before the US-China trade war was triggered in 2018, China constituted 22% of the US' goods imports. This share has since dropped to 18%. The US' latest across-the-board sanctions on Chinese companies in the semiconductor industry represent the country's latest efforts to contain Beijing's technology and military advances and indicate a further decoupling between the world's largest countries (see chart 9).

Chart 9: China's semiconductor industry has to increase its self-reliance



Source: GlobalData, Momentum Investments

This is likely to accelerate the decline in globalisation already underway, brought on by onshoring and nearshoring to reduce reliance on global supply chains.

How will a global slowdown and local economic and political challenges affect SA's outlook?

Against this backdrop of dimmer global growth, a slow grind lower in elevated inflation and geopolitically, a more fragmented world, growth in SA is set to moderate from 1.9% in 2022 to 1.4% in 2023. Recent negative political developments raising uncertainty over the leadership of the country pose significant downside risks to this view.

Lower growth in some of SA's main trading partners will reduce demand for our exports, leaving private demand and investment as the main contributors to growth.

Structural challenges and mounting headwinds will continue to dampen local demand, nonetheless. The pace of increase in nominal wages and social grants has failed to keep up with the latest surge in inflation, while employment prospects are weakening given continued downgrades to next year's expected growth outcome. Meanwhile, businesses remain constrained by softer expected demand, a staggered pace of economic reforms and policy uncertainty.

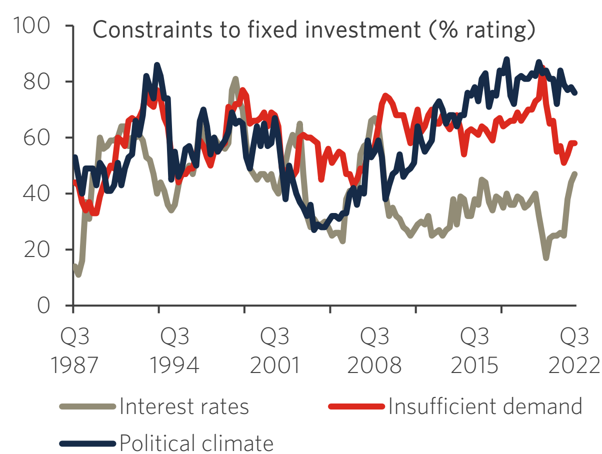
Although policy debates aired by the ruling party have moderated in recent quarters, particularly in areas concerning land reform, the nationalisation of the central bank and prescribed assets, uncertainty over a more permanent solution to extending the social relief of distress grant and the financial and operational viability of policies such as the National Health Insurance continue to hang in the air.

Moreover, uncertainty over Ramaphosa's continued leadership in SA, following his alleged failure to properly report a robbery at his game farm, has raised the risk of a slower pace of reforms and lowers government's ability to provide more predictable and stable policy outcomes. In a more negative scenario, in which a successor within the ANC does not continue to champion the reforms Ramaphosa has already set in motion, we could see an unwinding of progress in key areas, such as the fight against corruption and the reinstatement of SA's institutional credibility.

In our view, output remains further at risk from persistent disruptions at malfunctioning state-owned enterprises. Electricity outages have ramped up in intensity, with a third of offline generating capacity arising from unplanned outages. Crippling strikes, theft and vandalism have, in addition, undermined Transnet's contribution to economic growth given the entity's importance in transporting freight to local markets and ports. *BusinessTech* reports that, in 2021, SA's rail network carried the lowest volume in a decade. Not only does this cause further damage to SA's road infrastructure, but it also pushes up operational costs for businesses.

Although embedded generation projects are gaining traction and should underpin growth next year, the recovery in fixed investment is unlikely to be broad-based due to ongoing challenges suppressing business sentiment. According to the Bureau for Economic Research (BER), more than three quarters of manufacturers still cite the general political climate as an obstacle to investment in SA. This is expected to climb further on the back of recent unfavourable local political developments. Nearly 60% rate insufficient demand as a constraint and a rising share (from 17% in the third quarter of 2020 to 47% in the third quarter of 2022) agree that short-term interest rates are hindering investment prospects (see chart 10).

Chart 10: Policy uncertainty continues to hold back fixed investment



Source: BER, Momentum Investments

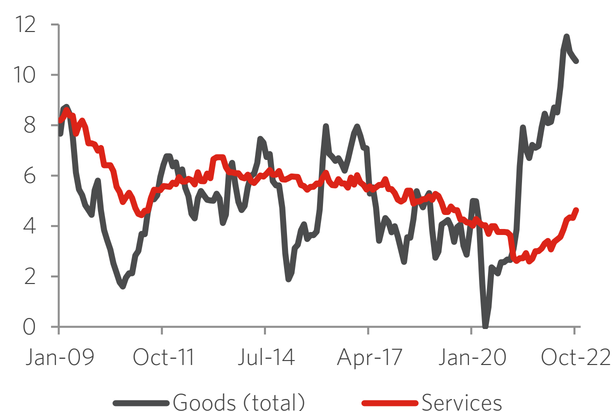
When will interest rates peak in SA and when will the SARB cut again?

Relative to many of SA's peers, the overshoot in the inflation target has been relatively modest. The high base effect created in food and fuel inflation should deliver a welcome reprieve in 2023. At an underlying level, wage inflation shows little signs of developing into a wage-price spiral. The rise in services inflation has also been tame, partly owing to above-average vacancies in the rental market, which has resulted in downward pressure on rental escalations (see chart 11).

Although inflation in rand-sensitive core goods has surprised to the upside, the rand could strengthen by

the end of 2023 on an improved global risk backdrop and a more conducive environment for capital flows into EMs. Inflation pressures, at a headline level, are expected to unwind from 6.8% this year to 5.7% next year. Though underlying measures of local inflation are likely to react with a lag, given a delay in pass-through effects, we anticipate core inflation to remain well within target in the medium term.

Chart 11: Modest rise in services inflation



Source: Statistics SA, Momentum Investments

Conforming with warnings heralded by the IMF and World Bank, the SARB cautioned against the risk of under-tightening and clarified that policy rates may expand beyond the neutral level if upside risks to the inflation trajectory are viewed as material.

We anticipate a further 50 basis points in the current series of interest rate hikes, leaving the repo at 7.50%. But we acknowledge the risk of additional tightening should inflation prove stickier than projected. If persistent local political uncertainty bids the rand weaker on a more sustainable basis, the outlook for inflation expectations could come under threat, leading to a tighter stance on monetary policy.

What are the risks associated with a greylisting event or further rating downgrades?

While decisive intervention by Treasury lowers the probability of a greylisting event, shortcomings in the hollowed out criminal justice system keep the probability as more likely than not. While investors are well versed on the structural challenges the country faces, limiting the impact of a greylisting event on SA asset classes, perceived inaction by SA to address the FATF's concerns or a reversal in anti-corruption reform efforts to date would result in a larger negative effect on economic and capital markets.

If SA displays a concerted effort to address the FATF's recommendations within an 18- to 24-month period, as was the case with Mauritius and Botswana, it could convince the country's counterparts to maintain relationships in the interim. Intellidex notes under this scenario, GDP losses would be less than 1% and any associated capital outflows would be small in magnitude and relatively short-lived. Intellidex paints a more bearish risk scenario, in which SA remains on the greylist for as long as five years. Without any convincing action by SA's policymakers, regulators and law enforcement agencies to address the FATF's concerns, SA could lose up to 3% of GDP in this worst-case scenario.

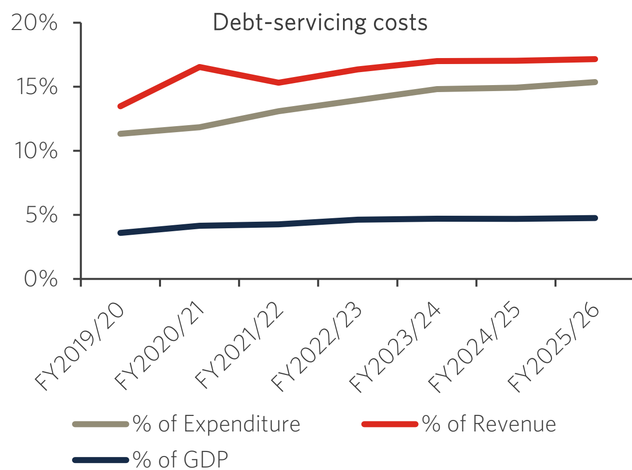
Although the rating agencies left SA's sovereign rating unchanged at the latest review, in line with expectations, we maintain our concerns over downward pressure on ratings in the medium to longer term on weak growth potential, an uncertain political outlook, rising socio-economic risks and increasing social demands on the budget.

The IMF has warned that fiscal policy should remain aligned with monetary policy in the next while to ensure that authorities can quell inflationary pressures. While fiscal authorities, locally, have promised to rebuild fiscal buffers and maintain a prudent approach to expenditure, the near-term improvement in SA's fiscal position has largely been thanks to a commodity price boon. In our view, this fiscal bonanza has merely masked underlying fiscal imbalances that the country has failed to resolve for over a decade, due to bad governance and anaemic growth. Real economic

stagnation forecasted in the medium term is suggestive of continued fiscal weakness ahead.

Despite some buffer built into the unallocated and contingency reserves, the fiscal consolidation path that Treasury has proposed, to stabilise debt in the near term, remains questionable given the exclusion of major risks in the baseline and an implausible spending trajectory. In our view, debt levels are already high, resulting in a large interest bill, crowding out more useful forms of government expenditure (see chart 12). Rising social demands and support for parastatals and financially bankrupt municipalities will only add to the challenge of stabilising debt at the proposed 71.4% of GDP in SA.

Chart 12: Government's interest bill crowds out more useful spending



Source: Treasury, Momentum Investments

The prospect of SA's sovereign rating returning to investment grade remains some way off in our view. This will rely on implementing growth-enhancing reforms to activate economic opportunities for poor households. In addition, deregulating the economy is viewed as a prerequisite for local businesses to grow, absorb labour and support sustainable revenue streams.

Moreover, curtailing growth in the wage bill and finding a long-term financial solution for state-owned enterprises, which creates economic value, can stabilise government finances in the long run. Conviction in government's willingness and ability to implement unambiguous policies quickly and efficiently can further jumpstart the economy and raise market confidence.

In this light, the outcome on the leadership of SA and the appetite to further the country's structural reform agenda remain critical to growth, investment and socio-economic outcomes.

The information used to prepare this document includes information from third-party sources and is for information purposes only. Although reasonable steps have been taken to ensure the validity and accuracy of the information contained herein, Momentum Metropolitan Life Limited does not guarantee the accuracy, content, completeness, legality or reliability of the information contained herein and no warranties and/or representations of any kind, expressed or implied, are given to the nature, standard, accuracy or otherwise of the information provided.

Neither Momentum Metropolitan Life Limited, its affiliates, directors, officers, employees, representatives or agents (the Momentum Parties) have any liability to any persons or entities receiving the information made available herein for any claim, damages, loss or expense, including, without limitation, any direct, indirect, special, incidental, punitive or consequential cost, loss or damages, whether in contract or in delict, arising out of or in connection with information made available herein and you agree to indemnify the Momentum Parties accordingly. For further information, please visit us at momentum.co.za. Momentum Investments is part of Momentum Metropolitan Life Limited, an authorised financial services and registered credit provider, and rated B-BBEE level 1.