momentum
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Market and economic outlook: January 2022

Highlights

Markets

- The transition from a stimulatory to a tightening policy environment and the anticipated slowdown in profit momentum point to a lower global equity return outlook in 2022. Rand strength is likely to erode local currency returns from global assets, including equities.
- The supply-demand dynamics for the United States (US) bond market is likely to deteriorate markedly this year. In conjunction with inflation that is proving to be more persistent than previously thought, these point to higher bond yields going forward. With interest rates still at historically low levels, global cash returns remain negligible. Some rand strength would further detract from rand returns.
- South African (SA) equity returns in the next year are likely to be driven by rerating rather than earnings.
- SA bond yields are attractive against their own history, as well as relative to those in developed and emerging markets (EMs), with part of the high real yield differential due to a fiscal risk premium. Smaller monthly inflation accruals should provide less fundamental support for inflation-linked bonds (ILBs) until the second quarter of 2022. After the recent rate hike by the SA Reserve Bank (SARB), the prospective SA real cash yield has risen to just above zero, which is more than one standard deviation below its historical average.
- Decent potential local property returns need to be weighed against negative fundamental risks and uncertainties.

Economics

- Cuts to projected global growth this year reflect a resurgence in COVID-19 cases and lingering supply-chain disruptions. These figures nevertheless remain above trend, arguing against fears of stagflation.
- We expect increased government influence and more emphasis on redistribution and structural changes in the Chinese economy, with a lesser focus on shorter-term cyclical outcomes.
- We expect a normalisation of household savings, an unwinding of supply chain bottlenecks and a return to the labour force to alleviate global inflation pressures.
- Milder global growth should soften the demand for SA's exports, while sticky unemployment will dull consumption spending. We see SA growth slowing from an estimated 4.9% in 2021 to 2% in 2022 and 1.8% in 2023.
- Restraining expenditures, defunct municipalities and increased allocations to financially- and operationally-ill state-owned enterprises (SoEs) remain key risks to SA's fiscal consolidation path.
- A tempered rise in rental inflation and reduced increases in medical aid tariffs are likely to drive an atypical response in local inflation. We expect headline inflation to average 4.5% in 2021, 4.6% in 2022 and 4.3% in 2023.
- Well-behaved inflation, anchored inflation expectations and a pedestrian growth outlook advocate for a moderate interest rate hiking cycle. We expect the SARB to hike interest rates by 150 basis points in the next two years.

Accommodative policy drove financial markets higher in 2021

Financial markets were buoyed in 2021 by an easing in COVID-19-related restrictions, an ultra-accommodative monetary and fiscal policy stance and a rebounding jobs market. The emergence of the new COVID-19 variant, Omicron and budding inflationary pressures nevertheless dented optimism in the final weeks of last year.

Global equities ended the fourth quarter of 2021 on a high note, up 6.7% for the quarter, propelled by strong gains in developed markets (DMs). For the year, global equities were up 18.5%. The MSCI DM Index was the primary underpin of stronger global markets in 2021, rising 21.8% in 2021 and 7.8% in the final quarter of the year. Meanwhile, EMs underperformed in response to supply-side shocks, which dented growth and raised risks to inflation. Moreover, EM assets underperformed as investors mulled over the end of the ultra-accommodative policy stance that many DMs adopted since the onset of the pandemic. The MSCI EM Index slipped 1.3% in the fourth quarter of 2021 and 2.5% for the year.

Despite new COVID-19 variants and inflation worries rattling investors throughout the year, accommodative monetary and fiscal policies in key advanced nations supported sentiment. The CBOE Volatility Index (Vix), or fear gauge, ended the year 5.5 points lower, dropping nearly 6 points in the final quarter of 2021.

The MSCI DM Index gained 21.8% in 2021 after rising 15.9% in 2020. Equity markets in the US and Europe supported gains in the DM composite, while Japanese markets lagged. The S&P 500 Index rose for a third consecutive year, ending 2021 28.7% higher. The rebound in the economy and in earnings, which started in 2020, continued in 2021 and boosted markets in the US. According to *Bloomberg*, the energy and real estate sectors were the best performers of 2021, followed by technology and financial shares.

The Eurostoxx 50 Index posted a healthy uptick of 24.1% in 2021, following a 2.5% drop the year before. Pandemic-related rescue packages and a confirmation from the European Central Bank (ECB) that it was unlikely to raise interest rates in 2022 supported European equities during the year despite the resurgent pandemic on the continent.

Japanese equities were the laggards from the DM composite in 2021 given slow growth in domestic demand, which failed to recover strongly despite the nation hosting the Olympic games. The Nikkei 225 Index climbed 6.7% in 2021, which was a narrower gain than the 18.3% increase the index achieved in 2020. The index lost 2.1% in the final quarter of last year.

Despite a stellar 27.1% gain in the Bloomberg Commodity Price Index for 2021, EM equities underperformed. The MSCI EM Index dropped 2.5% for the year, driven weaker by Asian and Latin American shares, while the MSCI Europe, Middle East and Africa Index (EMEA) surged. The market performance across EM diverged on the contrasting healthcare systems, varying government responses and a difference in capacity to provide fiscal and monetary policy support in the various countries. The MSCI Latin America Index dropped for a second consecutive year by 8.1%, following a 13.8% plunge in 2020. Asian shares ended the year 5.1% weaker, after rising 28.4% the year before. Meanwhile the MSCI Europe, Middle East and Africa Index gained 18% in 2021, after falling 6.9% in 2020.

Government bond yields stayed low, reflecting ongoing purchases by central banks. The US 10-year government bond yield moved 60 basis points higher in the year to 1.5%, while the German 10-year government bond yield remained in negative territory and ended the year at negative 0.2%.

The JP Morgan EM Bond Index (EMBI) spread displayed intra-year volatility but ended 2021 only 7 points higher. The EMBI spread spiked to an intra-year high of 353 points in early December, reflecting fears of a sooner-than-expected interest rate hike by the US Federal Reserve (Fed) and the spread of Omicron. Colombia (132 points), Argentina (120 points), and Turkey (85 points) were among the countries to

experience the largest deterioration in credit default swap (CDS) spreads since the end of 2020, while Poland (31 points) and Hungary (26 points) experienced the biggest improvements.

The local equity market followed global markets higher in 2021 and posted the strongest return since 2009. The JSE All Share Index soared ahead by 29.2% in 2021, supported by strong gains across all constituents (see chart 1). Resource shares climbed for the sixth consecutive year and ended 2021 32.3% higher, despite the international price of gold falling nearly 6% in the same period. Platinum and palladium prices declined by 8.5% and 19.9%, respectively in 2021. In contrast, Brent crude oil prices rose 54.3% last year in response to the energy crisis which unfolded globally, following a colder-than-anticipated winter in the Northern Hemisphere, low gas reserves and delayed maintenance projects.

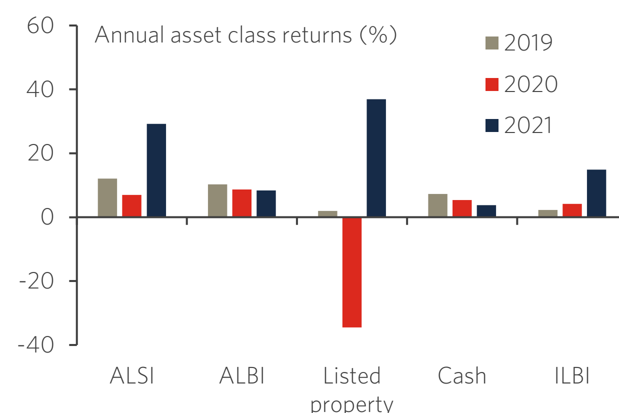
The FTSE/JSE Financials Index increased 29.8% in 2021 after falling 19.7% in 2020, while the FTSE/JSE Industrials Index strengthened 26.5% in 2021, after rising 12% the year before.

The FTSE/JSE Mid-cap and Small-cap indices performed well in 2021, increasing by 28.9% and 59.1% after dropping 14.4% and 0.3% in 2020 respectively.

In SA's fixed income markets, the 10-year government bond yield sold off 72 basis points. The JSE Assa All Bond Index rose 8.4% in the quarter, while the JSE Assa Government Inflation-linked Bond Index (ILBI) traded 14.9% firmer for the same period. Meanwhile, the FTSE/JSE SA Listed Property Index recovered 36.9% after plunging 34.5% the year before.

From SA's EM peers, the Turkish lira suffered the worst sell-off in 2021 (nearly 30%). This was followed by a 15% depreciation in the Chilean peso and the Colombian peso. The rand weakened by 7.8% against the US dollar in 2021. However, the rand depreciated by a lesser 1% against the euro (and 6.9% against the British pound) in the same period. SA's five-year CDS spread remained unchanged by the end of 2021 at 206 points but had reached a low of 180 points in the middle of June and a high of 250 in late November on the discovery of Omicron.

Chart 1: Returns from local asset classes (%)



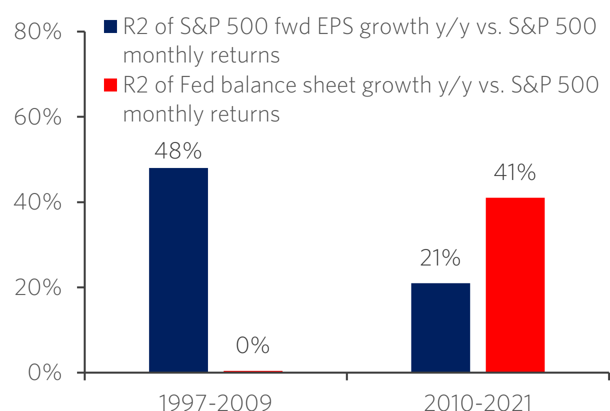
Source: Iress, Momentum Investments

Expensive global asset class valuations a major constraint on future returns

The abundant stimulus in 2020/21 hugely supported financial asset prices. The transition in the policy environment in 2022 (led by the US and the United Kingdom (UK)) from previous massive stimulus to less stimulus, then to no additional stimulus, and eventually to policy tightening, should culminate in a less conducive backdrop for asset class returns and could lead to periodic drawdowns in riskier asset classes. How important quantitative easing (QE) had become for equity returns is aptly illustrated by research from Bank of America showing that since the global financial crisis (GFC), QE has become twice as important as a driver for US equity returns than profits (see chart 2).

While the anticipated slowdown in profit momentum associated with lower global growth also points to a lower global equity return outlook in 2022, the magnitude and longevity of any potential equity sell-offs will be limited as long as the global economic recovery remains intact and broad based, as is currently still the case. At least the anticipated growth slowdown around the world should be mild enough to keep growth rates well above trend levels in 2022, in our view.

Chart 2: Drivers of US equity market returns



Source: BofA

The expected turnaround in the QE cycle going forward should be a negative fundamental demand factor for global bond yields. In the US, the Fed has been a major demand source for Treasury issuance since the GFC and again since the COVID-19 crisis, so much so that the Fed now owns around 30% of all outstanding US Treasury securities. But this Fed demand will recede as QE is tapered and then ends, at a time when Treasury issuance will rise further to fund huge fiscal programmes in the US. The supply-demand dynamics for the US bond market is hence likely to deteriorate markedly in 2022. In conjunction with inflation that is proving to be more persistent than previously thought, this points to higher bond yields going forward.

That caution is also warranted on global bonds as rising policy rates loom, is evident from a Citi analysis of US asset class behaviour at the start of previous rate hiking cycles. While US equities typically rally approaching the first Fed hike, bond yields rise in both the run-up to the first hike and during the first year of the hiking cycle.

What would be more problematic for equities is a spike in bond yields, for instance if the bond market perceives the Fed to be behind the curve on fighting inflation. Research from Bank of America shows that when US bond yields historically rose by 50 basis points in a month, returns for the US equity market were negative in the immediate aftermath of the spike, while returns up to a year after the spike were weaker than normal.

It would be difficult to argue that any of global equities, bonds or cash are currently exhibiting great value in isolation, with the US forward equity earnings yield around 3.6% at the time of writing, the yield on 10-year US treasuries around 1.5%, Japanese bond yields scarcely above 0%, German yields almost negative 0.3%, one-year US cash yields 0.6%, Japanese cash yielding just above 0% and European cash negative 0.5%. These expensive valuations put a major constraint on the future returns that can be expected from each of these global asset classes in 2022 and beyond. Furthermore, with the rand appreciating closer to fair value, this would erode the local currency returns from global assets for SA investors.

In terms of relative valuations though, global equities look cheaper than cash or bonds. On a normalised earnings yield gap basis (using earnings over the past decade), US equities are currently more than one standard deviation cheap versus bonds on long-term averages. At the current through-the-cycle earnings yield, US 10-year bond yields would have to rise closer to 2% to erase the equity valuation discount. Conversely, at current bond yields, US equities would have to rise by more than 30% to close the valuation gap.

If US real bond yields rise in anticipation of tighter monetary policy as we expect, this should benefit the rest of the world's (RoW) equity markets over the US market with its long-duration growth characteristics. In addition, as the US equity market has recently outperformed the RoW despite an inferior profit performance, it has opened up a record US forward price-to-earnings (P/E) premium.

Rerating the likely return driver for the SA equity market going forward

SA corporate profits benefited profoundly in the first half of 2021 from the stimulus-driven sharp rebound in global and economic momentum and the low earnings base of 2020. Continual earnings upgrades became the norm throughout this period. Unfortunately, this trend reversed in the second half of last year with the manifestation of a slowdown in global growth related to the appearance of the Delta COVID-19 variant around

the world. Apart from this global trend, local growth also buckled in the third quarter under the impact of civil unrest and more restrictive lockdowns. In response to these global and local growth trends, the SA industrial sector saw a downward slide in earnings revisions from the middle of 2021. Furthermore, SA resource companies also saw a peak in earnings revisions in the second quarter of 2021, which coincided with a peak in commodity prices driven by global supply and demand factors. This resulted in a less favourable earnings revisions trend for the overall SA equity market during the second half of 2021.

Whereas SA equity market returns in 2021 were derived from a strong profit rebound that overshadowed a valuation derating, this is likely to reverse in 2022, with pressure on profits expected from a slowing in global and SA economic momentum on top of the high profit base created in 2021. As such, returns will have to come from a rerating in market valuations. Fortunately, the SA equity market valuation picture looks quite favourable. Even assuming earnings growth of negative 15% in the next year, the SA equity market is now one quarter of a standard deviation cheap against the average since 1999. Also, SA equities still trade at huge valuation discounts to the RoW, with SA equities cheap versus EM equities (more than one standard deviation below long-term averages) and even more so against DM equities (around two standard deviations below long-term averages).

SA bonds compelling versus RoW and against other asset classes

The global spike in inflation has further eroded the real government bond yields available in DM, with most developed countries' real bond yields in negative territory. Although SA's inflation rate has also risen from a low of 2.1% in May 2020 to the current 5.5%, the high real yield still available on SA bonds is in stark contrast to those in the developed world and even among EM peers. It stands to reason that these high SA real bond yields already discount a high fiscal and country risk premium. Not only are SA real bond yields currently attractive versus DM and EM yields, but SA's real yield premium is also high against historical averages. Finally, SA's real yield is also almost one standard deviation higher than its own historical average.

In the ILB space, there should be some scope for further break-even widening in the interim, with inflation expected to peak in the first quarter of 2022. However, smaller monthly inflation accruals should provide less fundamental support for the asset class until the second quarter of this year. After the recent rate hike by the SARB, the prospective SA real cash yield has risen to above zero, which is still more than one standard deviation below its historical average.

Relative to SA equities and cash, SA nominal bonds have consistently been the cheapest asset class since 2013. Aggressive COVID-related SARB rate cuts have made cash the most expensive asset class since 2020, while sharp profit upgrades in 2021 have pushed SA equity valuations sharply down.

A lot of the negative listed property fundamentals looks to have been discounted

Sector fundamentals in the listed property sector remain negative, with rising vacancies; falling escalations; negative rental reversions with a focus on tenant retention and sharp rises in operating costs the order of the day. The negative structural factors of work-from-home (WFH) and desk-sharing also impact the office sub-sector. In the retail sector, too high rental costs to sales and e-commerce are additional threats, while the industrial sector faces weak capacity utilisation rates and electricity supply issues.

Our expectation is that listed property values will have to decline by between 10% and 15% peak-to-trough to account for these negative fundamentals. However, as values have already declined by 9.6%, we think a large part of the negative fundamental backdrop has already been discounted. In essence, decent potential property returns from here must be weighed against the fundamental risks and uncertainties in the sector.

At current trough distribution levels, the relative expensiveness of property versus bonds looks exaggerated. Assuming an exit SA bond yield of 9.5%, that dividends in the next year retrace halfway towards their 2019 level and that listed property returns are in line with our 8% base case, relative listed property valuations would be 9% cheaper than the historical average.

Gold price currently underperforming US real rates

With the fundamental driver for the gold price being the opportunity cost of holding a non-interest-bearing asset, it is unsurprising that US real interest rates have been the dominant determinant for the US dollar gold price in the last two decades. More surprising has been that movements in the US dollar no longer provide additional explanatory power for the behaviour of the dollar gold price.

Based on the current level of US real interest rates, the predicted value of the dollar gold price is about 6% above the current actual spot level, providing a positive tactical signal for gold exposure. In addition, we maintain that there is always a strategic rationale for gold as a portfolio risk diversifier due to its safe-haven characteristics during risk-off global bouts, as well as its limited correlation with other asset classes in a portfolio.

Learning to live with COVID-19 as an endemic illness

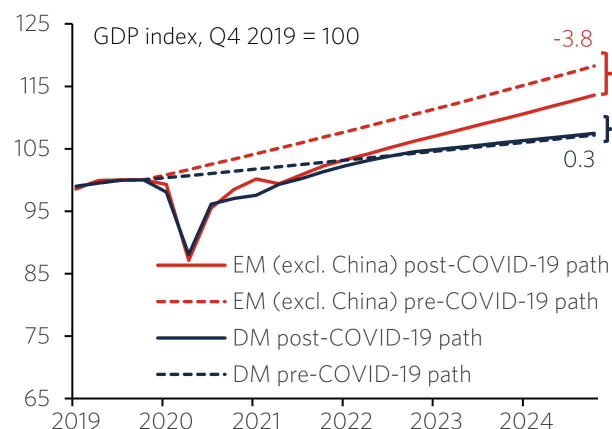
While achieving a high level of vaccinations is likely to protect swathes of the population against severe disease, this alone may not be enough to stop the COVID-19 virus from circulating across the globe. As we rounded off 2021, the new and more transmissible Omicron variant incited fear in financial markets and triggered fresh travel bans. With Europe entering its fifth wave of COVID-19, authorities and health officials have succumbed to the reality of having to adapt to living with the virus. Analysts have guided toward a lower growth outcome for the fourth quarter of 2021, as the latest surge in COVID-19 cases dampened consumer and business morale.

Global growth is set to moderate in 2022, from 2021, with independent forecasts ranging from 4.3% (World Bank) to 4.9% (International Monetary Fund (IMF)). Cuts to projected growth have been made in line with a resurgence in COVID-19 cases and lingering supply-chain disruptions, which have dimmed the outlook for the year. The Bloomberg median consensus forecast for growth in DMs in 2022 rose from 3.2% in January 2021 and peaked at 4.1% in September, before rolling over to 3.9% in November. Growth forecasts for 2022 for EMs followed a similar trend, increasing from 5.1% in January 2021, peaking at 5.3% in April and softening to 5% by November 2021. Nonetheless, these figures remain above trend, dispelling fears of a stagflationary outcome; a scenario in which high inflation coincides with notably weak growth. Commodity exporters are expected to bear the brunt of the growth slowdown in 2022 as the rotation from goods to services demand and lower commodity prices hurt commodity exporters disproportionately. Moreover, the lagged effects of tighter fiscal and monetary policy will result in more onerous financial conditions for these countries.

The future path of the pandemic will continue to shape the extent of economic scarring. Unlike what followed the GFC, this time around, the IMF expects EMs to suffer deeper economic scars, with low-income developing economies expected to be the laggards in this economic recovery due to adverse effects on skills acquisition and learning. JP Morgan notes that by the end of 2024, generous stimulus efforts are expected to leave DMs 0.3% larger than pre-pandemic trends would have suggested. The EM aggregate (excluding China), on the other hand, is expected be 3.8% smaller following on from less leeway for a larger fiscal response and a slower pace of vaccination rollout

preventing a further relaxation of restrictions on mobility, particularly in high contact sectors (see chart 3).

Chart 3: Longer-term pandemic effect on growth



Source: JP Morgan, Momentum Investments

Inflation could get worse before it gets better

The labour force participation rate has ticked up but remains far below pre-pandemic levels. This has left conditions tight in the labour market and has spurred anxiety in financial markets over a potential wage-price spiral. While entrenched early retirement trends and more permanent behavioural shifts in the labour market remain a risk to wage price pressures, in our view, the so-called Great Resignation could unwind as fiscal transfers run out for households (allowing financial strains to rebuild). More entrants may also return to the labour market, based on a relaxation of legal immigration of workers. Many of those who fell ill to COVID-19, or left work to care for sick family members, may, in addition, return to the workforce. Similarly, some older workers may choose to come back as health concerns subside.

Former US Secretary Larry Summers has warned that the American Rescue Plan would be too inflationary, but critics argue that without the aggressive action, to provide pandemic relief, we may have experienced another jobless recovery and weaker household balance sheets. Moreover, the IMF shows that expansions in the monetary policy base, which potentially blur the demarcation between monetary and fiscal policy, do not necessarily de-anchor inflation expectations if central bank actions are understood as an effort to target macroeconomic stabilisation goals instead of being perceived as acting on fiscal pressures.

Pent-up demand has been a distinguishing factor in driving inflation higher this time around, unlike the inflation experience of the 1970s, when supply shocks sent prices soaring and demand remained relatively unchanged. Under current conditions, supply has already started to recover but it has been unable to catch up to surging demand. Demand ballooned as lockdown restrictions were eased, unleashing accumulated savings and driving the prices of goods higher. Nevertheless, US household savings as a share of disposable income has dropped from a peak of 26.1% in the second quarter of 2020 to more normalised levels of 9.6% in the third quarter of 2021. Moreover, a rotation from goods demand to contact services will further help to correct the imbalance in the coming months.

Disruptions to logistics networks and capacity constraints have spawned supply chain disruptions, resulting in huge increases in freight costs and delivery times. Instead of addressing supply chain issues through interest rates, several measures can be considered to alleviate shortages. The US administration has increased efficiencies in custom clearances, adjusted import duties on essential raw materials and expanded operating hours at ports to ensure a smoother transportation of goods. Moreover, a switch to warmer weather in the second quarter of 2022 in the Northern Hemisphere should ease demand for oil and allow suppliers to ramp up oil balances, leading to a reversal in the oil price.

The IMF argues that longer-run inflation expectations present a relatively strong degree of anchoring, gradually trending back to 2% on average for DMs. Even in a worst-case scenario, which assumes continued strong increases in commodity prices and broader sectoral dispersion in inflation, inflation expectations are expected to revert in the medium term, after overshooting in the short term. As such, the IMF emphasises the importance of a well-communicated plan for a gradual exit from exceptionally accommodative monetary policy and observes that sound and credible communication can keep inflation expectations well anchored, without necessarily having to take aggressive monetary policy decisions.

With the US Fed considering an earlier end to its tapering of asset purchases, this could create space for the interest rate hiking cycle to commence in 2022. Though the unknown negative effect of Omicron on growth likely prompted a decision to keep interest rates steady in the UK in November 2021, fears of a wage-price spiral (exacerbated by the decrease in migration figures following the UK's exit from the European Union, namely Brexit) argue for a tightening in monetary policy.

Meanwhile, the medium-term inflation outlook for the Eurozone remains weak despite current transitory inflation pressures. The ECB's new symmetric 2% inflation target and more substantiative criteria for determining whether or not this target has been met, suggest, in our view, that current price pressures are not enough to trigger interest rate hikes before the end of 2023, at the earliest. While the Pandemic Emergency Purchase Programme (PEPP) is likely to expire early in 2022, the ECB is expected to ramp up its Asset Purchase Programme and may revise limits on holdings of sovereign debt to accommodate the expansion. Similarly, even while fiscal policy becomes more expansionary in Japan, the Bank of Japan (BOJ) remains committed to keeping monetary policy accommodative to support corporate funding. Moreover, the BOJ confirmed it has no plan to begin selling its asset holdings. In our opinion, low longer-dated inflation expectations and a tepid outlook on growth attest to a continuation of the BOJ's ultra-accommodative monetary policy stance for the foreseeable future.

China moves from "making the pie bigger" to "dividing the pie more evenly"

China celebrated its 100th anniversary of the founding of the Chinese Communist Party in July 2021. Here, President Xi Jinping announced that the party had achieved its first centenary goal, which was to build a moderately prosperous society and declared that the party was marching towards its second goal of building a great modern socialist country. Authorities in China have shifted their stance away from making the economic pie bigger towards focusing on higher quality growth and a more equitable distribution of gains.

Changes in China's demographics have urged this shift. Previously, a growing labour force necessitated higher levels of growth to accommodate many new entrants into the labour market. However, the negative consequences of the previous one-child policy have led to a shrinking labour market, urging Chinese authorities to focus on common prosperity for its citizens instead.

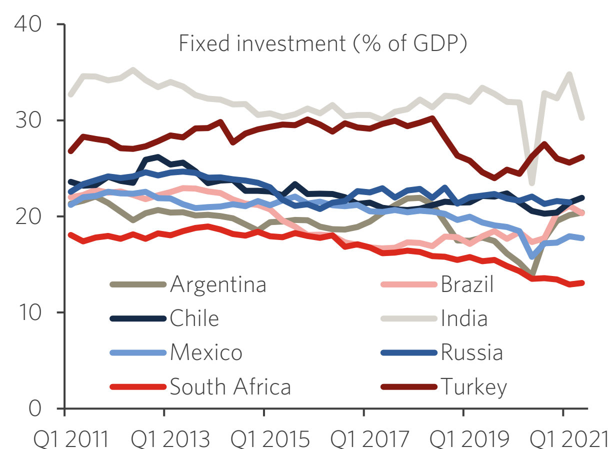
This bold level of restructuring, in which China has more willingly made aggressive policy changes, is more feasible in the context of a softer growth target, which gives authorities space to experiment. Under this shift in regime, the relative emphasis of China's policies will shift in favour of increased government influence, a more concerted focus on equality and redistribution, and a larger emphasis on structural changes in the economy, while concentrating less on shorter-term cyclical outcomes. Private sector firms and innovation will, nevertheless, unlikely thrive under these conditions and China may take longer to achieve its rebalancing efforts towards a consumption-driven economy. Under this regime shift, the ideological battle between China

and the US is set to continue on social systems and areas involving economics and politics. *The Economist* publication argues that conditions are ripe for China to challenge the US in terms of its relative perceived success of authoritarian governance against the US's model of democratic capitalism. While Beijing will host an orderly 20th party congress in the second half of 2022, America will be facing the risk of a divided government in the mid-term congressional elections in November 2022.

Economic rebound losing momentum in SA

Against a backdrop of milder global growth, shaped by less accommodative fiscal and monetary policy, demand for SA's exports are likely to soften. Moreover, even as a faster-than-anticipated rebound in wages spurred household spending in 2020, the dark cloud of lingering unemployment will take the shine off consumption spending in 2021. Tepid credit growth and further interest rate increases suggest that credit-driven purchases are unlikely to be a major contributor to household spending in 2022. Moving towards lower level of restrictions during the course of the year, will likely have a smaller positive effect on growth outcomes, unlike previously when larger sections of the economy were unable to operate. As such, we see growth slowing from an estimated 4.9% in 2021 to 2% in 2022 and 1.8% in 2023.

Chart 4: SA's fixed investment ratio has grinded lower



Source: World Bank, Momentum Investments
Data up to Q2 2021

While Treasury and the SA Reserve Bank (SARB) pitch SA's longer-term economic growth potential at 2%, this likely relies on the implementation of additional structural reform measures. In our view, trend growth remains capped by weak fixed investment trends. Growth data from the second quarter of 2021 showed that the construction sector was still 21% below pre-pandemic levels, with the next worst-performing sector (transport, storage and communication) only 12.1% weaker. SA's fixed investment to gross domestic product (GDP) ratio slipped to 13.1% by the middle of 2021, from 19% at the end of 2013 and remains below its EM peers (see chart 4).

Since the tabling of the February 2020 national budget, a number of growth-enhancing political and economic reforms have been introduced. More notably, the raised cap for electricity self-generation should unleash additional projects in the mining and minerals sector in particular. Moreover, new project announcements in relation to Bid Window 5 of the renewable energy independent power producer programme and secured concessional climate financing have been positive announcements in the energy space, while the prospect of private sector participation, to scale up capacity at the ports and reduce logistic costs, is likely to increase efficiencies and competitiveness in the logistics sector.

Despite these and other reforms in the areas of investment attractiveness and governance, a number of underlying measures in the World Bank's Worldwide Governance Indicator for SA have yet to show a marked improvement and in some cases (government effectiveness and rule of law) have shown a deterioration relative to a decade ago. While efforts to shore up institutional credibility have been noted by the major rating agencies, this pillar will remain under scrutiny in future reviews. A weaker medium-term growth and fiscal picture further weigh on SA's rating outlook in the medium term.

Election results complicate the growth and fiscal outlook

The evolution of SA's political scene is likely to affect both growth and the fiscal trajectory given the surprising electoral outcome of the 2021 local government elections. Firstly, the trend of stayaway voters became more entrenched, reflecting the decline in citizens' trust in key government institutions and authorities. Voter abstention appears to be the highest among younger age cohorts, threatening an expression of frustration outside of the formal voting channels and contributing to the already-high level of social delivery protests and unrest in SA.

Secondly, the election results revealed bruising losses for the largest political parties in SA, likely on the back of internal party dysfunctionalities, a poor economic setting and mismanagement at the municipal level. The largest victory was instead seen by the minority parties, where support doubled. These trends have given rise to a third observation, which is the rising trend of coalition governments given the record number of hung councils which emerged from the 2021 local elections. While last year's election outcome provides an opportunity to build more solid coalitions with smaller parties that have found themselves in a kingmaker position, a more fragmented political landscape presents challenges to fast-tracking key structural reforms to resolve low trend growth.

Some political commentators have warned that the results of the vote may tempt the introduction of more populist policies as the ruling party attempts to win back defected voters. If the focus has indeed shifted from more localised issues, such as service delivery, to concerns over national policy, this would pose a further threat to government's fiscal consolidation and debt stabilisation goals.

Though Finance Minister Enoch Godongwana's maiden budget broadly appeased financial markets (mostly thanks to an outsized revenue outcome following a commodity price boon, an upward revision to nominal GDP through a reweighting exercise and deferred decisions on expenditure items), the size of SA's (gross) debt burden is still large at R3.9 trillion. Risks to restraining expenditures, defunct municipalities and increased allocations to financially- and operationally-ill state-owned enterprises, in addition, remain high in our view. The two largest risks to the short- to medium-term expenditure profile arise from the civil servant wage bill and the undeniable need to address high levels of poverty in SA. Despite the compensation of government employees accounting for a smaller share of consolidated expenditure, the R20 billion overrun in the current FY was partly funded from the Infrastructure Fund. Time is running short for government and labour unions to reach a wage agreement for the next fiscal period and indecision by the end of March 2022 runs the risk of a continuation in the cash gratuity to government employees.

The second key risk to the short- to medium-term expenditure profile stems from high levels of poverty in SA. With the Social Relief of Distress grant set to expire at the end of March 2022 and nearly a third of SA living below the food poverty line, government needs to urgently address economic hardship for a large portion of the SA population. This is challenging in the context of SA already spending a high percentage of its wallet on social expenditure (3.3% of GDP relative to 2.1% in Argentina, 1.7% in Mexico, 1.5% in India or 1.4% in Brazil).

According to JP Morgan, bringing the population up to the food poverty line (R624 per month) will cost the fiscus an additional R30 billion every year, while raising living standards to the lower-bound poverty line (R890 per month to include some non-food necessities) will require R60 billion every year. While officials at Treasury have highlighted the need to cover these households in a deficit neutral manner, the decision was deferred to the February 2022 national budget. An expert team on the basic income support panel has recommended a phased-in approach, with the country's fiscal situation in mind.

A modest unwinding of an accommodative monetary policy stance

While potentially permanent increases in government spending threaten a looser fiscal policy stance relative to government's envisioned consolidation path, monetary policy has shifted into tightening mode. The SARB has expressed an interest to unwind its accommodative monetary policy stance and shift real interest rates into positive territory. While the SARB's quarterly project model (QPM) calculates a steep interest rate hiking cycle, resulting in interest rates of 5.75% by the end of 2023 and 6.75% by the end of 2024, in our view, well-behaved inflation, anchored inflation expectations and a pedestrian growth outlook advocate a more moderate interest rate hiking cycle. We expect the SARB to hike interest rates thrice (by an accumulative 75 basis points) in 2022 and a further three times (total of 75 basis points) in 2023. Hailing from a global and local backdrop of ultra-accommodative monetary policy, we do not see the neutral interest rate recovering as far as to 2.4% in the medium term as indicated by the QPM and, instead, see this rate closer to 1% by the end of 2023.

Although regulated administered prices (including electricity tariffs and water costs) and wage settlements pose an upside threat to SA's inflation trajectory, rental inflation and increases in medical aid tariffs are likely to prevent a surge in inflation outcomes given their weighty contribution to services inflation. Rental inflation is expected to rise into 2022. However, an overhang in housing supply, an increased number of first-time home buyers and reduced demand for rental in key nodes as work-from-home trends continue, will likely temper the rise in rental inflation. Moreover, medical aid schemes have guided towards lower increases in medical aid tariffs between 5% and 6%, which is lower than the longer-term average of 9.7%. The surge in global food prices is less likely to translate into soaring local food prices, subsequent to the drop in correlation in SA's food prices relative to global food prices, from 0.8 prior to the GFC to 0.5 after. This is particularly good news for lower income earners, who spend a significant portion of income on food. Elevated energy costs pose a risk to transport inflation (and indirectly to food inflation) in the near term, but warmer weather expected in the Northern Hemisphere, by the second quarter of 2022, should lower oil demand and allow a recovery in supply, driving oil prices lower. Petrol inflation accounts for 4.6% of the consumer basket, but the broader transport category (which includes vehicle purchases) accounts for an average of 13.9% for the top three highest income-earning deciles. We expect headline inflation to average 4.5% in 2021, 4.6% in 2022 and 4.3% in 2023.

A low level of currency passthrough further limits upside pressure to the path of local inflation from recent rand depreciation. Uncertainty over the spread of Omicron weakened the real effective exchange rate to one standard deviation below its longer-term trend.

The rand has since recovered (15.81 at the time of writing) but the rollover in SA's exported commodity prices will unwind recent gains in SA's terms of trade and as such will cap the extent of the rand recovery from these levels. Further out, we see a weakening bias embedded in the currency on elevated fiscal risks in the medium term and concerns around trend growth.

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