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May 2019 production growth fails to expand faster

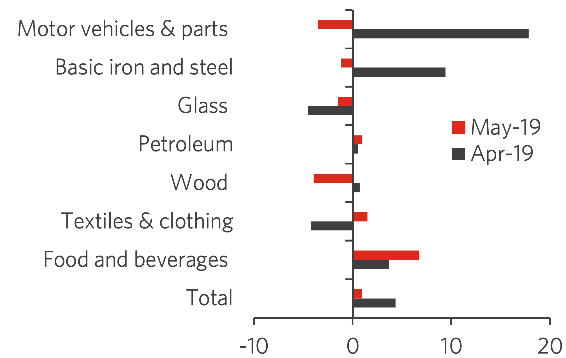
Highlights

- The manufacturing production growth print for May 2019 slowed to 1.0% from 4.3%, indicating a mild slowdown in growth momentum.
- The production of food and beverages, textiles and clothing as well as petroleum and chemical products contributed positively to the May 2019 manufacturing print. Year-on-year (y/y) growth detractors emanated from wood and wood products, motor vehicles and parts as well as basic iron and steel.
- Global manufacturing production trends continued to deteriorate in the second quarter of 2019. The global purchasing managers' index (PMI) remained below the neutral mark of 50 for two months in a row. This was the first time that the index has contracted below the neutral mark since November 2012.
- Production in the mining sector contracted again in May 2019, by 1.5% (previously negative1.2%), the seventh consecutive contraction.
- The largest detractors from mining production growth included gold, diamonds, iron ore and other metallic minerals. Coal, the platinum group metals (PGMs) and manganese ore mining contributed positively to the May 2019 mining production print.
- Local and global constraints continue to prohibit significant growth in mining and manufacturing production in the near term.

Manufacturing growth momentum slowed in May 2019

Statistics South Africa (Stats SA) released the manufacturing production print for May 2019, which slowed to 1.0% in y/y terms from 4.3% y/y (see chart 1). The month-on-month (m/m) growth rate declined to 1.5% in May 2019 from 2.5% in April 2019, indicating a mild slowdown (see chart 1). There was growth in only four out of the 10 manufacturing production divisions, compared to growth in eight production divisions in April 2019, further confirming the slip in momentum. Production in food and beverages grew by a significant 6.7% y/y (previously 3.7% y/y) and added 1.8% to the manufacturing production print in May 2019.

Chart 1: Growth in manufacturing production (% y/y)



Source: Stats SA, Momentum Investments

The last time this division grew at such a robust rate was in July 2018.

Production in textiles, clothing, leather and footwear grew 1.5% y/y, previously declining by 4.2% y/y. Although the division did not contribute meaningfully to the May 2019 manufacturing print, it did break the five-month contraction it had been in. Growth in petroleum, chemical products, rubber and plastic production improved to 1.0% y/y from 0.5% y/y in April 2019 and added 0.2% to total manufacturing.

Production in the wood and wood products, paper, publishing and printing division contracted by 3.9% y/y before growing by 0.7% y/y. It subtracted 0.4% from the overall manufacturing print. Growth in the motor vehicles, parts and accessories division deteriorated from significant double-digits in April 2019 (17.9% y/y) into a contraction of 3.5% y/y in May 2019, and removed 0.3% from manufacturing growth. Growth in the basic iron and steel, non-ferrous metal products, metal products and machinery sector slowed to 1.2% y/y (previously 9.4% y/y in April 2019) and subtracted 0.2% from the 1.0% y/y manufacturing print for May 2019. Global manufacturing production trends continued to deteriorate in the second quarter of 2019. The global manufacturing PMI fell from 49.8 index points to 49.4 in June 2019. Capital Economics cites it as the first time the index has remained below the neutral mark of 50 for two consecutive months since November 2012. The PMI fell across all the major economies in both advanced and emerging market economies, except for the United States and Brazil, indicative of weakness across the board.

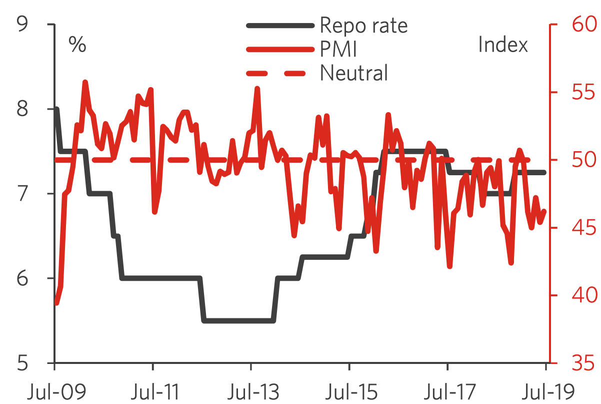
Although there were no significant load-shedding incidents in the second quarter of 2019, electricity supply interruptions remain a concern. Moreover, domestic demand remains lacklustre, holding back growth. A general slowdown in global demand and growth indicates local manufacturing production is likely to remain modest in the coming months. Talks of monetary policy easing across different advanced and emerging market central banks could help to reverse the downward trend in global production growth and sentiment, but further clarity on global trade developments is needed to stabilise sentiment.

Monetary policy intervention could help growth at the margin

Growth in SA is constrained by weak demand, policy uncertainty and rising input costs, which have dented sentiment. Monetary policy has also not been accommodative in the last 10 months, according to the South African Reserve Bank (Sarb). At the May 2019 monetary policy committee meeting three members preferred to leave the repo rate unchanged while two opted for a repo rate cut of 25 basis points.

The SA economy has been in a downswing since December 2013. However, the repo rate has been on an upward trajectory since then, only moderating halfway through 2016. A higher repo rate has coincided with weaker PMI readings and similarly, lower interest rates have been accompanied by more robust readings on the PMI (see chart 2). A cut in the repo rate could spur sentiment and help growth recover at the margin, but more certainty and the containment of input costs are necessary to drive more robust growth in the productive sectors of the economy.

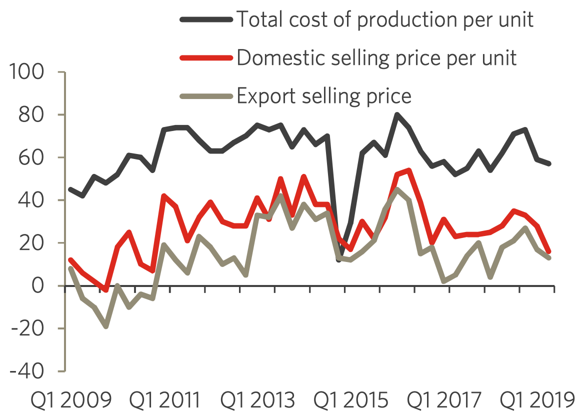
Chart 2: PMI and the repo rate



Source: BER, Sarb, Momentum Investments

The Sacci business confidence index improved to 93.3 index points in July 2019 from 93 index points in June 2019 and July 2018. The recent scrapping of the implementation of the R402 fixed surcharge for prepaid electricity for business users should help to contain input costs for smaller manufacturing firms that use prepaid electricity. Input costs remain elevated, however, given high municipal rates, steep electricity tariffs and heavy wage bills. As such the net balance of manufacturers experiencing a rise in input costs have outstripped those who have seen domestic and export selling prices increase (see chart 3).

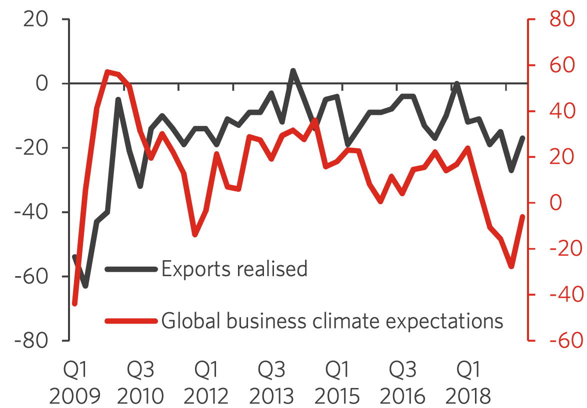
Chart 3: Input costs outweigh selling price (net balance)



Source: BER, Momentum Investments

There has been a pause in trade war rhetoric, but the risk of an escalation has not been completely neutralised, deeming it a threat to growth in global trade as well as for exported manufacturing goods produced in SA. The IFO global business climate expectations index has been in negative territory since the second half of 2018, which coincided with a more protracted decline in local manufacturing exports (see chart 4). A potential decline in manufacturing exports in the new anti-globalisation wave remains a growth concern for SA, exacerbated by weak domestic demand.

Chart 4: Trade weakened by negative business conditions (Index)

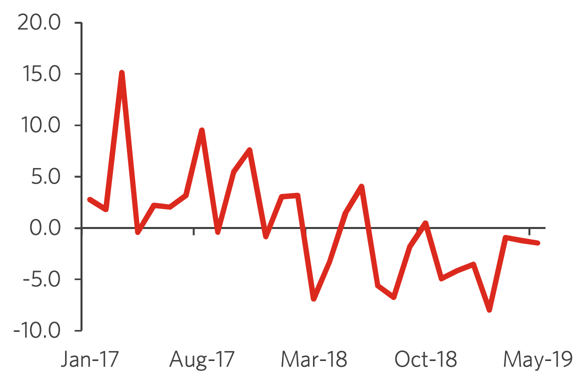


Source: BER, Bloomberg, Momentum Investments

Mining growth remains negative, but is moderating

Production in the mining sector contracted again in May 2019 by 1.5% y/y (previously negative 1.2% y/y in April 2019) as published by Stats SA (see chart 5). This is the seventh consecutive contraction for growth in total mining production. The sector however improved by 3.0% m/m, previously contracting by 1.8% m/m in April 2019. In the three months ended May 2019, mining production rebounded to 2.2% from the 0.6% contraction at the end of April 2019, citing a mild recovery in three-monthly momentum. A host of domestic constraints to SA's mining sector remain, including high electricity prices. The gold sector is still contracting by double digits and continues to weigh on mining production, despite the positive run in the gold price. Mining production growth for May 2019 excluding gold grew by 2.2% y/y, which was the third consecutive positive growth print for 2019.

Chart 5: Mining growth weak, but steadies

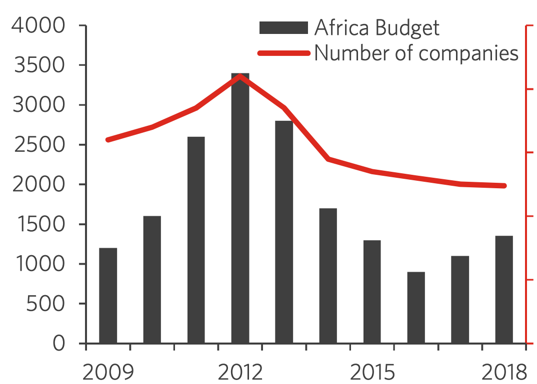


Source: Stats SA, Momentum Investments

The largest detractors from mining production growth included gold, which declined 24.4% y/y and subtracted 3.3% from total mining. This was followed by diamonds shrinking by 30.7% y/y and removing 1.7% from total growth. Iron ore and other metallic minerals declined by 5.2% and 9.8% respectively, and subtracted 0.7% and 0.6% respectively from total mining production. Coal grew by 8% and added 2.0% to mining production, followed by PGMs, which expanded by 6.8% and contributed 1.6% to the mining print for May. Manganese ore grew by a robust 29.3% y/y (growth levels last seen in February 2018) from 11.6% in April 2019. The index added 1.1% to the 1.5% y/y May mining print.

The SA mining sector also suffers from structural weaknesses, which can be explained by a contraction in exploration budgets as well as weak growth and support in junior mining. Budgeting for mining exploration has seen a decline in the share of global allocations to Africa from 14% in 2017 to 13% in 2018 (see chart 6). The SA share of mining has declined significantly to 8% in 2018 from 35% in 2002, according to Standard and Poor's (S&P) Global Market Intelligence. Countries like the Democratic Republic of Congo, Burkina Faso, Ghana, Ivory Coast and Mali are now the African leaders in exploration investment. SA however, has a monopoly in the PGM exploration budget (holding a share of 91.3%). PGMs have a weighting of 23.5% in the mining production index compiled by Stats SA.

Chart 6: Exploration budget for Africa (US$m)

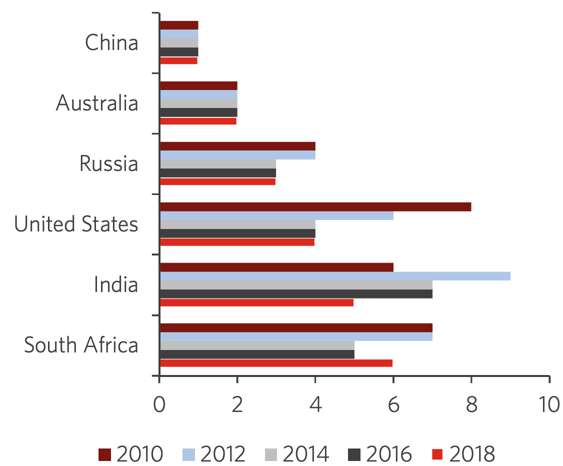


Source: S&P, Momentum Investments

Capital investment availability for junior miners remains scarce given that such investment has to be attractive to both local and international investors. Both Canada and Australia grant tax incentives to junior investors. But strict regulation in SA makes it difficult for international investors to supply capital to junior miners. The junior miners' programme, which is a partnership between the Department of Mineral Resources and the Industrial Development Corporation (IDC) to support junior miners by providing funding, could be a significant stimulator but the programme is still in its early stages.

The International Council on Mining and Metals (ICMM) compiles the Mining Contribution Index (MCI), which assigns a ranking to a country according to the significance of the mining sector's contribution to the country's economy. SA is still one of the top six countries that has the highest production value of metallic mineral and coal, but was unseated from fifth position by India in 2018 (see chart 7). China has remained the top performer since 2010, followed by Australia. SA continues to deteriorate in the various ranks across different performance indicators, indicative of a sector that requires intervention in becoming more investor friendly and conducive to growth.

Chart 7: Mining Contribution Index (rank)



Source: ICMM, Momentum Investments

A number of local and international constraints continue to prohibit significant growth in mining and manufacturing production in the near term. However, Momentum Investments' well-diversified outcome-based solutions provide protection against SA economic weakness. It has appropriate exposure to local fixed income investments that benefit from the poor-performing economy and low inflation, and has meaningful global exposure unaffected by weak local growth conditions, while gaining from the rand weakness likely associated with fragile local growth conditions.