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Analyst certifications and important disclosures are at the end of this document.
Introduction

2017 looks to be a year in which growth risks are skewed to the high side, not the low side. But, a better global growth outlook comes with heightened political risk. This comes not only from the ramifications of last year’s shocks, such as Trump’s election victory in the US and the Brexit decision in the UK, but also from a spate of elections in the euro zone. If nothing else, it looks set to be a year of volatility in financial markets.

It is reasonable to believe that growth in Sub-Saharan Africa is closer to finding the bottom. The performance of countries that have prioritised investment spending, mostly relying on external financing, will continue to outperform those of commodity-producing countries that typically rely on domestic savings to finance investment spending.

From an SA political perspective, 2016 was a bruising year. The year’s extraordinary volatility was largely determined by the seismic changes brought about by a dominant ruling party losing its once casually assumed hegemony on the popular vote; a president scrambling for re-ascendancy after an epochal political miscalculation, and in doing so fanning wider internal discord in the party he leads; and a body politic, best represented by a restive student population, growing increasingly frustrated by the stubbornly torpid pace of economic growth and transformation.

We expect that 2017 may be a relatively quiet year for SA economics in comparison with the uncertainty and volatility which will be provided by domestic politics, commodity prices, US monetary and trade policy, and global geo-politics. We think that these dynamics are likely to be the biggest drivers of SA asset prices as opposed to fundamental domestic macro factors such as growth and inflation, which we think are largely known and priced.

Our view is still that rand weakness will fade, based on the underlying fundamentals. We define rand weakness on approach of 14.00 – 14.50. As base case, we still expect the rand to move closer to 13.00 against the dollar. At this stage we pencil this level in closer to year-end but the currency may well move there sooner.
Global outlook 2017

2017 looks to be a year in which growth risks are skewed to the high side, not the low side. But, a better global growth outlook comes tinged with heightened political risk. This comes not only from ramifications of last year’s shocks, such as Trump’s election victory in the US and the Brexit decision in the UK, but also from a spate of elections in the euro zone. If nothing else, it looks set to be a year of volatility in financial markets.

Solid basis
We look for global growth this year to be in the 3.5%-4.0% range, compared to last year’s likely outcome of between 3% and 3.5%. It’s not a huge step up, and many will claim that major economies are still mired in a secular stagnation stranglehold. But momentum seems to be improving, with much of this coming from the US. It seems fair to say that Trump’s shock election victory last November has galvanised the corporate sector, no doubt spurred on by the prospect of a twenty percentage point cut in the corporate tax rate. Many have compared Trump’s fiscal strategy as similar to that of Ronald Reagan in the 1980s. We think that there’s some truth to this. The key is whether fiscal action and an ‘America first’ stance will re-awaken the dormant animal spirits within firms that seem to have been asleep in the US (and much of the rest of the developed world). The initial signs seem good, with many leading indicators pushing ahead strongly (Figure 1).

Our growth forecast of 2.7% for the US this year lies above the FOMC’s median 2.1% call and the 2.2% rate that forms the Bloomberg consensus of near 70 analysts.

While it’s very plausible that this optimism could fizzle out quickly, we are more hopeful that it will not. Hence, our growth forecast of 2.7% for the US this year lies above the FOMC’s median 2.1% call and the 2.2% rate that forms the Bloomberg consensus of near 70 analysts.

Ordinarily we might argue that faster US growth will help pull others up given the US’s role as the great global consumer. But the Trump administration’s focus on trade deficit reduction could weaken the link between US growth and that of the rest of the world, especially those that export heavily to the US, such as China and Mexico. But, even taking this risk into account, we believe that global growth can improve this year, helped by signs of better momentum in the Eurozone, China and commodity-producing emerging-market economies.

Political risks
While the economic outlook might have brightened, there are some aspects of the political outlook that have grown a lot darker. For a start, there are the ramifications of some of the shock outcomes we saw last year such as the US election, the UK Brexit vote and the failure of the constitutional reform referendum in Italy. We’ve mentioned that the incoming Trump administration may have many positive effects on the...
economy stemming from things such as tax cuts and regulatory reforms. But there could be some very damaging changes as well, such as the imposition of punitive tariffs on large exporters to the US. Well before Trump was elected the global tide had turned towards a more nationalist agenda, with protectionist policies on the rise and global trade on the wane (Figure 2).

**Figure 2: Rising protectionist policies**

![Graph showing rising protectionist policies](source: Global Trade Alert)

Even if the overall economic ramifications of the shock outcomes of Brexit and Trump prove benign, they certainly seem to create the prospect of much greater financial market volatility. Trump tapped into this mood, as did the Brexiteers in the UK who successfully engineered an EU withdrawal decision from the electorate in the June referendum. Starting this year, those who voted for Trump and Brexit – and those that did not – will face the consequences of these decisions. Even if the overall economic ramifications of these shock outcomes prove benign, they certainly seem to create the prospect of much greater financial market volatility as the winners reveal their plans.

The crucial question is whether the better global growth outlook will be knocked off course by the ramifications of last year’s shocks in the US and UK and the elections to come in Europe; we think not. The crucial question is whether the better global growth outlook will be knocked off course by the ramifications of last year’s shocks in the US and UK and the elections to come in Europe. We think the answer is ‘no’ but discovering the answer to these questions could lead to significant amounts of financial market volatility through the year. And if this volatility becomes sufficiently intense and disruptive, it will surely undo any good work that might have been done by recent political shocks and any that might occur in the future.

**Fed to deliver**

For policymakers, navigating this maze of economic and political risks will be a big challenge. Nowhere is this greater than in the US given that the Trump administration could unleash significant fiscal expansion when the economy is already close to – or at – full employment. FOMC members took this risk on board at the last meeting in December not just by lifting the fed funds target range another 25 bps to 0.5% – 0.75% but also by forecasting more rate hikes next year (three) than previously (two). The money market and bond market in the US responded to Trump’s victory in a similar sort of manner but, as is customary, financial markets continue to price in a more benign
monetary tightening cycle than the median FOMC forecast envisages (Figure 3). In our view the likely outcome this year will be a rate-hike profile that is closer to the FOMC’s view than that of the market. This being said, it seems unlikely that the Fed will rush the rate hikes through early in 2017 as it, like everybody else, will need more clarity on the budget outlook. Hence, we think that the rate hikes won’t start until the June meeting.

Other central banks in major developed nations are still some considerable way behind the Fed in the monetary policy cycle. Indeed, it is somewhat ironic that consistent calls from the likes of G20 for countries to engage in fiscal easing to lift growth have only really been answered by the one country – the US – that no longer seems to need such action. Countries with the fiscal room – and need – to ease, such as Germany, remain steadfast in their opposition. Only Canada has embraced the fiscal easing strategy with the same gusto that the new US administration is promising. The result is that the burden of economic support outside of North America still lies with the central banks in places where fiscal policy remains stymied such as Japan and the euro zone. And the upshot of this is that their central banks will have to continue to supply significant monetary accommodation. The ECB is already locked into a year-long program of quantitative easing, while the BoJ is committed to holding the 10-year JGB yield close to zero. It might be the case that neither central bank has to add any more monetary accommodation than this but recent talk that the ECB, for instance, might need to cut short its bond-buying plan because of rising inflation seems very premature.

**Bond cycle turning?**

The prospect of easier fiscal policy in the US and a faster pace of Fed tightening have only served to feed the view that the long-running bull market in government bonds has come to an end. However, it would be wrong to put such a sentiment shift down to the outcome of the US election alone. Bond yields in the UK have risen dramatically following the Brexit vote last June, and yields in the euro zone have moved higher as well on issues such as rising inflation and political risks. Only Japan of the major nations has been able to buck the trend of rising long-term yields but this has been done by the Bank of Japan adjusting its JGB purchases to keep 10-year JGB yields close to zero. This policy effectively relinquishes control of the BoJ’s balance sheet and, in our view, that’s always a dangerous thing to do, just as the Swiss National Bank found out when it tried to stop euro/Swiss from falling below the 1.20 level. In the end that policy had to be abandoned, such were the pressures on the balance sheet, and the BoJ could experience similar problems if international yields soar and the BoJ does not lift the 10-year JGB target. We suspect that the BoJ will be reticent to lift the JGB target rate, not least because it would signal monetary tightening at a time when the inflation rate is still a long way below the 2% target.

The BoJ’s success in holding its zero percent 10-year JGB target will be heavily dependent on the movement in treasury yields. If these continue to rise significantly, the pressure to adjust the JGB target or abandon the yield curve control policy will
We suspect that treasury yields will continue to rise, with 10-year yields set to move into a 3.0%-3.5% range late in the year.

Better growth, higher inflation, fiscal easing and tighter Fed policy should all lift US yields and so exert a ‘pull’ factor on yields internationally even if, as we suspect, yield increases in the US outpace other major nations.

Better growth, higher inflation, fiscal easing and tighter Fed policy should all lift US yields and so exert a ‘pull’ factor on yields internationally even if, as we suspect, yield increases in the US outpace other major nations. The rotation out of government bonds and into ‘riskier’ assets such as equities should be another factor in the equation as investors fear the end of the bull cycle in government bonds. Quite clearly there might be events in 2017 that force a return to the safety of the bond market and force yields back down again. A political upset in one of the many euro zone elections this year could generate such an outcome. A ‘trade war’ between the US and China could do the same although it is notable that China, amongst others, has been shedding treasuries for some time. Indeed the pace of net outflows from treasuries by overseas central banks has been remarkable (Figure 4). It might only be the flip-side of the currency intervention that China and others have had to do to limit FX weakness, but it does remove one pit-prop from the treasury market, and it does bring into question how foreign official investors will react should the Trump Administration start a trade war with China and others.

Figure 4: Falling fast

Source: Reuters datastream

Forex uncertainties

A number of factors will affect major currencies this year. The dollar will presumably be driven by the policy choices of the Trump administration and how the Fed chooses to respond. In Europe, politics will be the key, with the euro governed by the outcome of a number of national elections and the pound heavily influenced by the likely start of Brexit negotiations. In Asia, the yen will be driven largely by treasury yields given that the BoJ is holding the 10-year JGB yield close to zero and the treasury/JGB spread is a key factor determining the yen. However, there will be a secondary factor here as well, which will impact other Asian currencies as well, most notably the Chinese renminbi. It is the prospect of trade reprisals from the US. So, while we expect dollar/yen to press on...
to 130 as treasury yields rise, local policymakers may have to lean against the wind of dollar strength, even if only verbally, to stop excessive yen weakness from making it onto the US Administration’s radar screen. The same goes for dollar/renminbi, which we expect to reach at least 7.30 in 2017.

Dollar strength against Asian currencies should be mirrored elsewhere, with euro/dollar, for instance, expected to fall to 95 cents. Stronger US growth, fiscal easing and faster monetary tightening are all part of this story. There is one additional factor as well, which is the likelihood that the US Administration will reduce the tax rate on company profits that are repatriated to the US. Estimates suggest that US firms are holding around USD2.5tr of profits overseas (Figure 5). These have risen fivefold since President Bush Jnr invoked a similar tax holiday in 2005. Of course we can’t be certain that Trump will choose, or be able to see through this plan. We also can’t be sure that large numbers of firms will take up the offer. And, even if they do, much of the cash that’s parked overseas could be held in dollars and hence have no bearing on the greenback’s value if it is repatriated to the US. However, in spite of all these issues, we see a fair risk that this factor could aid the dollar; indeed, just the anticipation of its implementation could create speculative dollar purchases by investors.

But, while the dollar might gain more strength in the early stages of the Trump presidency, we have to bear in mind that the new administration is vowing to reduce the trade deficit and a much stronger dollar could clearly frustrate this aim. The ‘strong dollar’ policy that’s effectively been in place since Robert Rubin became treasury secretary in 1995 might be ditched for something that’s more in keeping with the aim of trade deficit reduction. So, while the first 6 – 12 months of the Trump presidency could see the dollar’s trade-weighted value rise by 5% – 10%, we’d expect this entire rise, and more, to be reversed in time.

Emerging market recovery
A moderately stronger outlook for developed country growth should help growth in emerging and developing nations to move up into a 4.5% – 5.0% range this year from a likely 4.0% – 4.5% last year. Emerging economies have grown on average a bit below 5% per year since the early 70s, and hence this year should see a return to that average. But, as mentioned previously, it is possible that protectionist pressures weaken the link between developed country growth and that of developing nations. The most obvious sign of this is the wall across the Mexican border threatened by president Trump. But there are many other friction points between the US and other emerging market nations, especially China, as well as the wider rise in protectionist actions we described earlier. The headwinds for many emerging market countries also include a faster rate-hike cycle from the Fed as this could hurt those countries that have borrowed in dollars on an unhedged basis. Perhaps fortunately, many such borrowers have been warned by the likes of the IMF and BIS to temper their enthusiasm for cheap dollar funding, and

The Economy in 2017
14 February 2017

Figure 5: The overseas cash pile keeps growing

<table>
<thead>
<tr>
<th>Year</th>
<th>Estimated foreign cash holdings of US companies (USDtr)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>0.5</td>
</tr>
<tr>
<td>2003</td>
<td>1.0</td>
</tr>
<tr>
<td>2004</td>
<td>1.5</td>
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<td>2013</td>
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<tr>
<td>2014</td>
<td>6.5</td>
</tr>
<tr>
<td>2015</td>
<td>7.0</td>
</tr>
</tbody>
</table>

Source: Standard Bank Research

The ‘strong dollar’ policy that’s effectively been in place since Robert Rubin became treasury secretary in 1995 might be ditched for something that’s more in keeping with the aim of trade deficit reduction.
the message seems to have got through. With this in mind, we take a slightly more optimistic view of growth in emerging and developing nations this year.

**Figure 6: Looking for improvement**

![Emerging and developing countries GDP growth rate](image)

Source: IMF

**Investor perceptions**

The economic growth story might look a little brighter for emerging market nations; but, will global investors see this as sufficient to counterbalance the international political risks that have mushroomed in the past few months and the local political problems that still exist for many countries? Investment in emerging market bonds and stocks has been on a downslope for some time, with the fledgling recovery in inflows last year upended at least temporarily after the US presidential election. We suspect that global investors will remain cautious towards emerging market assets until the dust settles on the Trump presidency, at least with respect to the new administration’s relationship with key emerging market nations such as China and Russia.

**Figure 7: Rebound over?**

![Portfolio inflows into EM assets](image)

Source: Bloomberg

The Sino-US relations could well hold the key to not just China’s economic and financial market performance this year but also that of other emerging economies. For instance, commodity prices have recovered nicely thanks, in part, to stronger demand from China and this has clearly helped commodity-producing emerging market countries. Undoubtedly it does seem as if some commodity prices may have overheated somewhat as a result, such as iron ore but, given our call for China’s growth this year to come in around the 6.5% mark, we anticipate that the country’s performance will act as a help to other EM nations, especially in the region, not a hindrance. But China’s economic performance could clearly be set back by some of the trade-related threats coming from the new US administration. President Trump bemoans the way China has allegedly manipulated its currency for competitive gain. That might have been a valid accusation in the past but at the moment the PBOC is working tirelessly to prevent renminbi weakness. China has shed a quarter of its reserves since the spring of 2014 and there’s no sign that this is about to stop. Indeed, sabre rattling from Washington could turn a
flood of capital outflows into a torrent as individuals and businesses fear trade restrictions from the US. We expect the renminbi to fall to the 7.30 region against the dollar this year but, if the flood becomes a torrent, this level will be surpassed substantially. Worse still, Beijing could retaliate by essentially giving the US what it wants: a freely floating renminbi, except that this would clearly produce dramatic currency weakness and not the strength that the Trump administration wants to see. Needless to say, a trade/currency war of this type would decimate emerging market currencies and other assets. We doubt that it will come to this but the mere possibility of such a dire outcome could be sufficient to keep EM investors on the defensive.

Glass half-full
There’s no doubt that the performance of emerging market economies and their financial markets could be hindered by external events, rendering investors reticent to put cash to work in emerging market stocks and bonds. Three Fed rate hikes this year could pose a challenge, as that’s quite a step up from the single hikes that we have seen in 2015 and 2016. Allied to this, rising inflation and the prospect of fiscal easing in the US should lift treasury yields still further, possibly eroding the carry-trade attraction of many emerging markets. There’s also the threat of protectionism emanating from the US and political risks in Europe associated with the UK’s Brexit decision and the raft of national elections in the euro zone.

And yet, for all these risks, we take a glass-half-full view of emerging markets. Economic growth is likely to be stronger overall, and past and future commodity price strength should prove beneficial for many. Also we should not forget that many emerging markets have been pulled through the wringer in recent times and could offer value now, or in the near future, for emerging market investors. Countries that come to mind here include the likes of Brazil, Russia and possibly Turkey in the future. Allied to this is the fact that global investors have been cautious when it comes to investment in emerging markets. It is very possible that likely fiscal changes in the US, such as corporate tax cuts, could help keep this developed-market bias for a little while longer. But eventually investment flows into emerging markets should recover more profoundly although, as we’ve mentioned, this does require a year in which the external risks listed previously prove benign, not malign.
ECONOMY
LIVE
Sub-Saharan Africa
Phumelele Mbiyo
Sub-Saharan Africa in 2017: constructive outlook

Closer to finding the bottom

It is reasonable to believe that growth in Sub-Saharan Africa is closer to finding the bottom. The performance of countries that have prioritised investment spending, mostly relying on external financing, will continue to outperform those of commodity-producing countries that typically rely on domestic savings to finance investment spending.

Despite protestations to the contrary, it seems as if policymakers in commodity-producing countries that have opted to prevent their currencies from adjusting to a lower commodity price environment have done so out of a determination to prioritise consumption over investment spending. The consequence of this policy choice has generally been that domestic savings in those countries have fallen, depriving such economies of the financing required to bolster investment spending. Invariably, overall GDP growth has been undermined by a deterioration in the trade balance. Yes, lower commodity prices have played a role in depressing exports, but the unwillingness to restrain consumption spending has also ensured that imports remain far more elevated than would have been the case if policymakers had sought an appropriate macro adjustment to the low commodity price environment.

The Rwandan experience is instructive in this respect and indicates that a predilection for bolstering investment spending allows a country that is going through something of a balance of payments shock to continue growing solidly nevertheless. In the past two years exports of metals – mainly cassiterite and coltan – declined significantly, leading to a widening of the current account deficit.

What’s more, financial inflows also came under pressure as some government loan disbursements were delayed. Yet the government opted to restrain recurrent spending, leading to a moderation of imports. It still sought funding from the International Monetary Fund (IMF), and initially allowed the currency to bear the brunt of the adjustment. The upshot has been a much more subdued slowdown in economic activity even as international foreign exchange reserves have been clearly under pressure.

The respective central banks continue to ration foreign exchange supply to favoured sectors of the economy, maintaining exchange rates at levels that are probably overvalued, and thereby, arguably, also inadvertently discouraging investment spending.

By all accounts, these lessons have not been accepted by Nigerian or Angolan policymakers. The respective central banks continue to ration foreign exchange supply to favoured sectors of the economy, maintaining exchange rates at levels that are probably overvalued, and thereby, arguably, also inadvertently discouraging investment spending. As a consequence, it is much harder to foresee a significant recovery in economic growth in these economies. Perhaps the only silver lining is that economic growth is unlikely to deteriorate much further over the coming year. Indeed, we may have even passed the worst point in the adjustment process. But the rationing of foreign exchange in these economies will continue to undermine the appropriate adjustment process, restraining economic activity.

Could structural factors keep growth persistently depressed?

Our preferred narrative to characterise the challenges that have led to average growth in the continent subsiding to an estimated growth below 2.0% in 2016 from mostly over 5.0% before 2014, as measured for Sub-Saharan Africa by the IMF, has not hinted at structural factors. It is very hard to construct a narrative in which structural factors are constraining growth of many countries on the continent. Indeed, we see the slowdown as having been primarily instigated by a cyclical slowdown in global demand.
In principle, these countries could have stimulated aggregate demand. However, it has been pretty clear that some countries’ capacity to boost economic growth by stimulating domestic demand is limited. Mauritius, for example, has slowed down to an annual growth rate consistently below 4.0% in the past five years from well over 5.0% in the 1990s. Several attempts by the government to boost demand by increasing infrastructure investment since 2008 have not made a dent.

The economy may actually have some structural constraints. The central bank has identified low savings and lack of productivity growth as factors holding back the economy. Perhaps to that list may be added demographic factors, specifically slow population growth, that has depressed labour force growth. For an island nation, with a small population, there are clearly limited avenues to stimulate economic growth via domestic demand.

Of the economies that have experienced a persistent decline in economic growth over the past decade, perhaps Mauritius is exceptional in having a strong case that such a slowdown has been exacerbated by structural factors. Even attempts to boost exports, by sponsoring the development of new industries for example, would still be limited if the authorities were not to attract the requisite skills.

With specific reference to commodity-producing countries, a key concern is that the dislocation in FX markets has effectively been caused by policymakers’ unwillingness to allow their currencies to depreciate. As a consequence, the required macroeconomic adjustment is not happening.

There is also some nascent anecdotal evidence pointing to a predilection of these policymakers for prioritising consumption rather than investment spending. This is most clearly evident when considering the experience with budget execution of Angola and Nigeria over the past year. The Angolan government hardly spent anything on infrastructure in the first six months of 2016. Similarly, the Nigerian government has been well behind schedule in its infrastructure spending plans.

In both cases, funding pressures were the most likely cause. In Nigeria’s case, not only was revenue generation below budget, but the government struggled to obtain the external financing it required. The experience of Angola was fairly close to that. For these governments to rely on domestic funding sources, it seems inevitable that they must accept rising domestic interest rates.

The longer the status quo remains, the greater the risk that growth may remain depressed for a prolonged period. Of course, an increase in commodity prices that would restore the ability of these economies to generate the domestic savings they used to enjoy would eliminate those risks.

Commodity prices: trending sideways

January began with OPEC and some non-OPEC members implementing oil production cuts that were agreed in December 2016. In the immediate aftermath of the agreement, oil prices jumped higher, with Brent crude trading above USD56.00/bbl, after having been stuck between USD45.00/bbl and USD50.00/bbl for about six months.

Copper prices also rallied strongly, rising by some 28% between late October 2016 and early December. Interestingly, despite this spurt, consensus market forecasts are effectively implying a rather flat trajectory for copper prices over the course of this year. We are inclined to believe that prices are not likely to decline on a sustainable basis from current levels, but will rather trend sideways on a multi-month basis.
The supply-demand dynamics for some commodities may not be amenable to sustained increases in prices. Take crude oil prices for example. While the reduction in supply has bolstered prices in the near term, the magnitude of the increase has been fairly small thus far. It is not entirely clear that there is potential for prices to rise much from current levels. The arrangement has no credibility given that OPEC members have a well-documented tendency not to comply. Furthermore, US supply would most likely rise if prices were to rise further.

Figure 8: Direction of commodity prices is uncertain, but likely not down

For African commodity-exporting countries, the implication is that it is unlikely that there will be much deterioration in economic performance. Neither is there likely to be any further deterioration in balance of payment metrics even for these countries. Even then, policymakers in these countries should not look up to a resurgence in commodity prices to bring about macroeconomic rebalancing in those economies. Moreover, it may take a long time for those countries that are rationing foreign exchange supply to stop doing so.

Unavailability of FX, not its price, is still the more pervasive risk

There is nothing that suggests that policymakers in Angola and Nigeria are about to devalue their currencies. Importantly, even in countries with currencies that are not depreciating or foreign currency is not in short supply at the moment, there is no assurance that the situation will remain so.

Take the Zambian kwacha. There is much to suggest that if the correct policy choices are made the kwacha would, at worst, depreciate only marginally over the course of the next 12 months. The Bank of Zambia has maintained a tight policy stance since late 2015, ensuring that Treasury bill and bond yields would remain elevated, mainly in excess of 20%. That policy tightness has constrained economic activity, dampening import demand as well. High interest rates on government paper also attracted foreign portfolio investment inflows, helping to keep the exchange rate reasonably stable since mid-2016.

Of course, even as the exchange rate has remained stable, there are still signs that major economic adjustments are required. Foreign exchange reserves have continued to decline, a sign that financial inflows are not sufficient to cover the current account deficit. Further policy tightening is required. However, inflation, which spiked to 22.2% in March 2016, dropped to 7.5% by December. So, the risks are now weighted towards the central bank easing the monetary policy stance.

But such an easing would most likely boost domestic economic activity sufficiently to increase import demand. This would also likely push Treasury bill yields lower, eroding...
the attraction of Treasury bills for foreign investors. The upshot could very well be further downward pressure on foreign exchange reserves.

Another reason that foreign investors were attracted to Zambian Treasury bills and bonds was because of assurances by the government to restrain fiscal spending and seek financial assistance from the IMF. Government debt as a percentage of overall gross domestic product has been increasing in recent years. Fiscal deficits have been elevated, and, as pointed out above, the yields on government paper has been elevated. Left unchecked, these developments could lead to a fiscal crisis in coming years. The government needs to restrain fiscal spending in order to avert such a crisis. Additionally, that fiscal restraint would lend a hand in bolstering the country’s balance of payments by reducing import demand. Financial assistance by the IMF would lend credence to the government’s fiscal consolidation effort, thereby mollifying foreign investor concerns.

But failure to embark on a program to reduce the fiscal deficit and seek financial assistance from the IMF could undermine confidence in the kwacha. So, while it is currently stable, the exchange rate could depreciate in much the same way as it did in 2015. As was the experience then, acute shortages of foreign exchange would be the bigger constraint for businesses operating in the country rather than the price thereof.

These same concerns would become pertinent in other economies of course, if their currencies were to come under pressure. The experience of the past two years or so suggests that policymakers are prepared to disrupt the optimal functioning of the foreign exchange market in order to preserve the appearance of calm in the market. Invariably in those instances, foreign exchange shortages become pervasive.

**Weather influences still relevant**

Drought in Southern Africa seems to be easing. As a consequence, food production is likely to be revived, helping to moderate food inflation pressures. Food inflation in countries like Namibia, Malawi, Mozambique, Lesotho etc. rose substantially in 2016. In some cases, food inflation rose to well beyond 15.0%. Those pressures will reverse course over 2017, helping to pull down overall inflation.

In contrast, parts of East Africa have been experiencing rainfall below normal. As a consequence, food price pressures are already becoming evident. There are fears that the drought in Kenya could be the worst in decades. As typically happens during drought-induced food shortages in East Africa, Ugandan food inflation is likely to rise the most.

**Political risks: some hotspots**

Of the countries that have national elections this year, perhaps the Democratic Republic of the Congo poses the highest risk of major instability. On paper, President Kabila will step down in December this year. Constitutionally, his term ended in 2016. However, elections, which should have been held in November, were not organised. The electoral body cited the complexity and cost of the process, indicating that it would only be ready to organise them in April 2018.

Any sort of instability in the DRC runs the risk of emboldening the numerous militia groups that are still operating in the east of the country. Moreover, there is also the risk that neighbouring countries could see the need to intervene. However, the United Nations already has a large mission in the country, with an intervention brigade that is mandated to organise offensive operations against rebel groups in conjunction with the army. A leadership vacuum would potentially compromise this mission.

The process leading up to the Kenyan elections in August will be a noisy affair, no doubt exacerbated by other politically contentious developments. Even then, the risk of a
major conflagration, similar to 2007, appears highly improbable. At the insistence of the opposition, the Independent Electoral and Boundaries Commission was disbanded. The process of replacing these commissioners surely added to the complexity of the exercise. Additionally, parliament amended the amendments to the Election Laws Amendment Bill. A contentious clause is one that would allow the IEBC to manually verify voters and transmit results. All these processes will likely lead to mass demonstrations that will capture media attention.

The Angolan elections, also in August, will probably also be relatively uneventful. The only mystery is who the presidential nominee for the ruling Movement for the Liberation of Angola (MPLA) will be. President dos Santos has created intrigue by apparently indicating his intention not to run in the elections. Notably, this was after accepting his re-election by the ruling party as party president. The party also nominated him as its presidential flag bearer. Then there were reports to the effect that the party would nominate the vice-president of the party to be the presidential flag bearer when the party celebrated its 60th anniversary. Somehow this did not happen. In the meantime, voter registration is going ahead. The second stage of the voter registration process will run until March.

African Eurobonds: further spread compression

Even after accounting for intermittent, transitory bouts of increased global risk aversion, it looks likely that African sovereign Eurobond spreads will compress further. There are a number of important events that carry with them considerable uncertainty. Perhaps chief amongst these will be pronouncements by President Trump. Additionally, there are important elections in Europe, and the Brexit process, that could roil market sentiment.

Of course, spreads of African Eurobonds have been declining over the past 12 months. Since January 2016 the spread of the Standard Bank Africa Sovereign Bond Index (SBAFSAO) over Treasuries declined by over 280 basis points. Events that took the market by surprise, like the Brexit vote and President Trump’s election victory, temporarily caused a spike in spreads.

Figure 9: Spread compression continuing apace

Arguably, the market was mollified by the generally precautionary posture taken by developed market central banks in response to these key events. The Fed stood pat for most of 2016, while making dovish noises regarding the Brexit vote. On the other hand the BOE actually eased the policy stance following the vote. The ECB was tied up in its easing efforts. A number of countries are likely to come to market. Kenya, which was looking to issue last year, opted to tap the syndicated loan market instead. But other countries, like Nigeria and possibly Angola, could be looking to issue paper.
SA politics in 2017

From a political perspective, 2016 was a bruising year. The year’s extraordinary volatility was largely determined by the seismic changes brought about by a dominant ruling party losing its once casually assumed hegemony on the popular vote; a president battling for re-ascentancy after an epochal political miscalculation, and in doing so fanning wider internal discord in the party he leads; and a body politic, best represented by a restive student population, growing increasingly frustrated by the stubbornly torpid pace of economic growth and transformation.

2017 will present a different type of volatility – one dominated by the battle for the ANC’s leadership. Though this may present a degree of calm to the markets, the underlying threat of a major disruption in December will continue to shake sentiment towards the country’s political outlook. Further, vigorous demands by the ANC for “radical economic transformation” have the potential this year to unsettle perceptions of the country’s longer-term policy course.

The ANC’s succession battle will be an all-consuming political theme for the year. Early signs suggest that the primary battle will be between Deputy President Cyril Ramaphosa and African Union Commission Chairperson Nkosazana Dlamini-Zuma. Yet there are other party leaders whose aspirations cannot be underestimated – such as ANC chairperson Baleka Mbete, ANC treasurer Zweli Mkhize, and Free State Premier Ace Magashule. If the 2007 and 2012 elective conferences are anything to go by, then rival factions will each put forward ‘slates’ of their preferred top six leaders, hoping to ensure that all their candidates are elected as a bloc and that challengers are completely side-lined. Given the intensity of the ANC’s current internal strife, such a winner-takes-all approach may threaten a further split in the party, one substantial enough to undermine the ANC’s grip on the national majority in the 2019 elections. Given the spectre of this outcome, there is still the chance that a compromise slate could be formed – one led by Mr Ramaphosa, deputised by Dr Dlamini-Zuma, and including some of the other top six candidates currently sparring for political elevation.

The all-important consideration regarding the succession debate will be how the ANC’s provincial leadership clusters choose to align themselves in the months to come. As it stands, and according to the most recent member figures, KZN still holds the largest share of party membership (21%), followed by the Eastern Cape (16%). The “premier league” has seen its proportionate influence lift with the three provinces that comprise this cluster now accounting for 30% of total ANC membership (Figure 10).

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Elsewhere, social stability will continue to be tested by frustrations emanating from the stubbornly tepid pace of economic growth: growth, though swifter than 2016, will remain far too low to allow any real tackling of the “triple threats” of poverty, unemployment and inequality that the ANC continues to lament. Social stability will be further fanned by the ANC’s internal succession dynamics as rival factions at both branch and provincial levels battle vigorously for the ascendancy as the party’s elective conference, to be held in Gauteng between 16 and 20 December this year, approaches. Further, on 31 March this year the South African Social Security Agency (SASSA) will assume control, together with the Department of Social Development, of the distribution of social grants to the almost 17m beneficiaries across the country every month. This is a monumental undertaking which has been necessitated by last year’s Constitutional Court ruling which determined that the tender awarded to CPS, which current distributes grants on behalf of the state, was irregularly awarded. Any delay or carelessness in distributing grants could have serious social consequences, and trigger profound unrest if these delays are not properly managed.

For the political opposition, 2017 will present the dual challenge and opportunity of consolidating recent gains – which for the DA will primarily focus on the need to display a discernible improvement in the management of the metros it now runs following last year’s municipal elections – while simultaneously finding new levers through which to secure public sympathy, and from which to assume the moral high ground, as the convenient strategy of assailing President Zuma’s failings begins to lose its lustre. Of the three new metros that the DA now controls its task will be the most straightforward in Nelson Mandela Bay, where we expect the DA to be able to use its recent electoral gains as a means through which to expand its provincial (and racial) reach. The reasons for the relative ease in NMB are simple: first, the metro was particularly poorly run by the previous ANC administration (prior, at least to former mayor Danny Jordaan’s hasty intervention), registering as one of the worst offenders nationally in the Auditor General’s review last year in terms of “irregular” and “wasteful and fruitless” expenditure. As a result of this, even the most incremental governance enhancements are likely to yield fairly profound results. Further, the DA holds a far stronger majority in NMB than it does in either Tshwane or Johannesburg, meaning that its ability to govern is not constrained by the need to retain the support (or at least the vote) of the EFF in the metro (Figure 11).
As far as labour relations are concerned, we expect a continuation of the broadly more stable labour outlook in 2017 that has been reflected in the prior two years. The resolution, until 2019, of wage talks in the platinum and auto sectors adds underlying calm in this regard, while public sector wage talks are expected again in early 2018 given that the current three-year agreement expires on 31 March of that year, as too are gold sector wage talks (given the expiry of the three-year deal struck in 2015). In the year ahead the potential for disruption is likely to be most pronounced in the metal, steel and engineering (manufacturing) sector negotiations, which will be led on the labour side by NUMSA. In the mining industry negotiations are expected at Kumba Iron Ore, and throughout the coal sector.

The threat of a downgrade to junk status will loom large this year, as it did in 2016. Barring any drastic move from the president to shore up his authority in cabinet (which may trigger an immediate ratings review), ratings agencies will announce their updated reviews of the country’s sovereign credit status in June – the same month that the ANC gathers in Gauteng for its five-yearly policy conference (when the demands for ‘radical economic transformation’ will likely be formalised) – and again in December, when the ANC gathers to elect new leadership. Politics, and the shape and intensity of potential change in this regard, will therefore again be a central element for ratings agencies in their determination of the country’s credit status this year.

Though any decisive reform will remain unlikely until the ANC’s succession outcome has been defined, there will be select opportunities this year for those in the ANC, the private sector and civil society to exploit in order to introduce creeping economic and even institutional reforms. Perhaps most clearly, we expect the ANC’s caucus in parliament, led by a more assertive chief whip Jackson Mthembu, to attempt to regain legitimacy by assuming a position in key matters which is more in line with public sentiment – such as in the inquiry into the errant former board at the SABC and the role of the broadcaster’s former Chief Operating Officer Hlaudi Motsoeneng. Meanwhile, the “work streams” established last year between National Treasury and the private sector, championed on the side of the latter by Telkom Chairperson Jabu Mabuza, hold the opportunity this year of yielding some outcomes – enough, potentially, to embed the seeds of a more healthy relationship between the state and the private sector.

Though the context for the year ahead appears to be somewhat more benign than the year that has passed, there are clear risks to political stability and market calm in the year ahead. For any real resolution to the stifling factional uncertainty in the ANC, and which has a deep and lasting national impact, we await the resolution of the ANC’s leadership battle.
SA economy in 2017: shallow cycles vs. optimism that politics will improve in 2018

While we expect that GDP has bottomed and inflation is peaking, the cycle is heavily dependent on politics and commodity prices.

We expect that it may be a relatively quiet year for SA economics in comparison with the uncertainty and volatility which will be provided by domestic politics, commodity prices, US monetary and trade policy, and global geo-politics. We think that these dynamics are likely to be the biggest drivers of SA asset prices as opposed to fundamental domestic macro factors such as growth and inflation, which we think are largely known and priced.

We agree broadly with consensus expectations, that SA inflation will peak in Q1:17, and, while growth will remain structurally low and below potential, cyclically it has troughed and will gain momentum in 2017 – aided by the end of the domestic drought and higher commodity prices. SARB’s and Treasury’s forecasts for SA GDP growth (1.1% and 1.3% respectively) and inflation (6.2% and 5.8% respectively) are relatively realistic, which reduces policy risks.

We expect GDP growth of 1.4% y/y in 2017, up from 0.4% last year. Post re-weighting by Stats SA and a higher oil price assumption, we have revised our CPI forecast to 6.0% y/y (previously 5.9%), down from 6.3% y/y in 2016, and expect that rates will remain unchanged in 2017 after rising 75 bps in 2016 and 200 bps in total since January 2014. Our outlook assumes that the USDZAR will remain resilient despite political volatility, supported by better fundamentals, and average 13.25 in Q4:17 (Figure 21).

We anticipate that the current account deficit (CAD) will narrow in 2017 to 1.7% of GDP from an estimated 3.8% of GDP in 2016, although this is heavily dependent on commodity prices remaining near current levels, as most of the narrowing comes from the trade balance which we forecast will remain in surplus in 2017. The net income deficit will remain in deficit but is likely to narrow from 3.8% of GDP to 3.3% of GDP as offshore equity markets outperform versus 2016.

With respect to growth, SA’s biggest risk apart from political volatility will be the outlook for commodity prices and global growth. Following the significant improvement in commodity prices in H2:16, we revised our GDP growth forecast for 2017 from 1.0% to 1.4%. Because the outlook for commodity prices is uncertain, with the fundamental underpin not well understood, we assess risks to growth to be to the downside.

With respect to inflation, risks lie to the upside due to the oil price as well as food inflation, specifically red meat and poultry price inflation, which may rise by more than we anticipate.

With respect to the repo rate outlook, we expect a volatile year, and that at different times pressure will mount for both a hike and a cut.
Qualitative assumptions

Our forecasts, specifically for the currency and interest rates, depend on political noise remaining in line with that of 2016, and assume that the National Treasury is not ‘captured’ by those looking to push through projects such as the nuclear build programme, which could be fiscally ruinous. We assume that investors, particularly offshore investors, will be tempted to look through the noise of 2017 in anticipation that firstly much of this is known and merely a continuation of what had started in late 2015 – and is therefore priced to some extent, and secondly that 2018 will be cyclically stronger from a domestic demand perspective. If this is the case, we expect portfolio inflows to be broadly supportive of asset prices and the ZAR.

GDP outlook

If commodity prices remain near current levels, GDP could recover to 1.4% in 2017

We expect that GDP growth will be driven by cyclical factors in 2017, and accelerate from its trough in 2016 which we estimate will average 0.4%. The current cycle is shallow and the drivers are mild; inflation is set to slow from 6.3% to 6.0% and our outlook for the repo rate is that it is likely to remain unchanged this year, versus 75 bps worth of increases in 2016, and we foresee pressure for both a cut and a hike to build at different times over the year. GDP growth over the next three years is expected to remain structurally below potential and importantly below population growth of 1.6%.

A recovery in GDP growth in 2017 is predicated primarily on a recovery in net exports, and will be most sensitive to global growth and commodity prices. If we exclude the most recent rally in commodity prices (i.e. Oct 2016 – Dec 2016), our estimate for GDP growth in 2017 would average 1.0%, rising to 1.4% in 2018 (Figure 14). This growth outlook assumes that a weighted index of SA’s export commodity prices falls marginally, by 4.1% y/y on average in 2017 (Figure 13). However, if we assume the recent rally is sustained, such that SA’s export commodity price index is on average 6.7% higher than it was in 2016, we could see GDP growth recover to 1.4% y/y in 2017 (see Table 2 for more detail on our commodity price assumptions).

- **Higher export growth due to a recovery in commodity prices.** A weighted index of the price of SA’s commodity exports rose 18% y/y in Q4:16, and we expect it will rise by a further 23% y/y in Q1:17 (in USD) (Figure 13), taking net exports from -R43bn in Q3:16 to -R0.5bn in Q4:16 and R30bn in Q1:17 (Figure 12). In a scenario in which commodity prices remain near current levels, net exports remain in surplus and average R29bn in 2017 after being in deficit in 2016 (we estimate net exports averaged -R19bn in 2016).
- **Our recovery in exports is also dependent on global growth** averaging 3% (Figure 15).
- **Net exports will also be driven by a continued contraction in import growth,** by 1.4% y/y on average for the year as consumption slows and investment remains in contraction (Figure 12);
- **The end of the drought** in SA should see the country return to being a net exporter of maize in Q2:17 after being a net importer in 2016.
Domestic demand: GDE to trough in Q3:17

- Real private consumption expenditure (PCE) growth averaged 0.8% in 2016 (according to our estimate), and we expect that it will slow to 0.2% in 2017 in response to last year’s interest rate hikes, combined with tighter fiscal policy and continued job losses. Lower inflation should buffer these forces to some extent. We anticipate subdued growth in real disposable income (Figure 16) and for lenders to remain risk-averse for at least the first half of the year. Our forecast for employment growth is -0.8% in 2017 (Figure 18). This is equivalent to 108,000 cumulative net job losses.

- Cyclical PCE is expected to remain in contractionary terrain until 2018, while non-cyclical PCE is estimated to remain slow but in positive territory (Figure 17). PCE growth is expected to remain below potential throughout our forecast period (to end 2018). Potential PCE growth is estimated to average 1.9% in 2017. Theoretically, this consumption gap should allow monetary policy to remain accommodative.

- Real fixed investment is projected to have contracted 4.2% y/y in 2016 as business sentiment struggled to recover to pre-2008 levels (Figure 19). In 2017,
fixed investment is estimated to average -1.9%, rising to 2.5% in 2018 as confidence levels begin to pick up in response to a more stable electricity supply and reduced political uncertainty. Fixed investment has averaged 20.2% as a percentage of GDP since 2010 but is projected to remain below this average in the forecast horizon.

Inflation is expected to average 6.0% y/y and fall back within the target band in June. Risks lie to the upside due to the oil price, food inflation, and the exchange rate pass-through.

After the reweighting by Stats SA as well as assuming a marginally higher oil price in Q1:17, we have revised our CPI forecast for 2017 up slightly, from 5.9% to 6.0% versus SARb’s forecast of 6.2%. This would still imply some moderation from an average of 6.3% y/y in 2016, although as with growth the inflation cycle is relatively shallow. Our 2017 forecast assumes oil averages USD53/bbl over the year, versus an
The inflation trajectory

We expect inflation peaked in December at 6.8% y/y (Figure 20). It may remain at 6.8% y/y in January and February, falling to 6.5% in March. Under our current oil and USDZAR assumptions, CPI should fall below the 6.0% target band in June for the first time since August 2016, to 5.7% y/y. There is likely to be volatility in headline CPI due to petrol price base effects (Figures 22 and 23) with CPI possibly printing above 6.0% again in September. We expect CPI to end the year at 5.5% y/y.

Two supply side factors should ensure that inflation moderates over the next few months:

- **Firstly**, oil price base effects are positive in 1H2017: oil rose from USD35/bbl on average in Q1:16 to USD47/bbl in Q2:16 and USD51/bbl in Q4:16. Using our assumption that oil will average USD54/bbl in 1H:2017, inflation in the price of oil peaks at 74% y/y in January and falls sharply to average 12% in Q2:17 (Figure 24).

- **Secondly**, the maize price peaked in January 2016 and has been in decline since February 2016 while the wheat price has been in decline since May 2016. Agricultural PPI inflation peaked at 25% y/y in February 2016 (due to wheat and maize prices) and has already fallen to 8.1% y/y.

In addition:

- **The Safex wheat price has started to fall** towards export parity on expectations of a healthy domestic harvest in 2017, and global wheat futures on average for 2017 are trading below the average wheat price in 2016. The Safex wheat price started to deflate year-on-year in September 2016, and we expect it will remain in deflation until August 2017.
- **We expect the Safex maize price will continue to fall**, from import parity to export parity, post SA’s domestic harvest in April. Currently import parity trades at just over R1,000/ton above export parity.
- **The stronger USDZAR should also assist inflation to moderate versus 2016**, although base effects will become less positive over the year (Figure 23); the USDZAR averaged 15.82 in Q1:16 and 15.00 in Q2:16 and we expect that it will average 13.63 in H1:17.
Inflation risks

There are several sources of uncertainty with respect to the inflation outlook in 2017:

- **Firstly**, the exchange rate pass-through (ERPT), which has been falling by our estimates since 2010, may be starting to rise, or at least appeared higher according to the December 2016 data release, which will have implications for core inflation throughout the year.
- **Secondly**, food inflation has been sticky in recent months, with the fall in maize and wheat not being passed onto consumers as yet, despite weak demand (Figure 25). We suspect that pass through from wheat to cereals and bread will pick up at the end of February, once we have more certainty with respect to the 2017 domestic maize and wheat harvests. February rains will be critical to securing the bumper harvest expected and food prices may only respond to the fall in agricultural commodity prices once this year’s harvest is confirmed.
- **Thirdly**, we do not expect poultry prices to feel the full effect of lower maize prices, which will keep meat inflation elevated, due to:
  - Recent legislation, implemented in November, which has capped brining of frozen IQF chicken at 15% down from an estimated average of 40%. IQF chicken accounts for around 42% of the total chicken market. This will raise the price of IQF chicken per kilogram in 2017 versus 2016, despite lower feed costs.
  - DTI (Dept. of trade and industry) placed a 13.9% import tariff on chicken from the EU, which was implemented in December. The DTI may raise the import tariff again at some point this year. Industry is requesting import tariffs of 37%.
- **Fourthly**, the oil price remains a risk to our forecast and we have run some scenarios to look at the effects of a higher versus lower oil price. If oil rises to USD60/bbl by May and stays there, our model estimates that CPI would average 6.2%, ending the year at 5.8% y/y.

### Table 1: 2017 CPI scenarios assuming different oil price trajectories

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Brent (USD/bbl)</th>
<th>CPI (%/y/y)</th>
</tr>
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<tr>
<td>Average in 2017</td>
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<td>5.9</td>
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<tr>
<td>Worst case</td>
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<td>6.0</td>
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<tr>
<td>Middle case</td>
<td>55</td>
<td>6.0</td>
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<tr>
<td>Best case</td>
<td>59</td>
<td>6.2</td>
</tr>
</tbody>
</table>

Source: Standard Bank Research
Repo rate outlook

If inflation declines as we expect to 5.5% by the end of the year, and the nominal repo rate remains unchanged at 7.0%, the real repo rate should rise from 0.2% currently to 1.4%. This could in theory give the SARB room to cut rates, especially if 1.) Growth remains below potential 2.) The currency is well behaved, supported by stronger global growth and higher commodity prices and 3.) The inflation differential between the US and SA falls as expected (Figure 26). This scenario assumes that emerging markets do not face a sudden stop scenario due to global risk events.

However, we expect the repo rate will remain unchanged in 2017 and that the SARB is more likely to cut when some of the uncertainties, both global and domestic are behind us – yet again, 2017 is littered with event risks.

The SARB may also want to cut only once inflation is more firmly within the target band. Because inflation is anchored so close to the upper end of the target band, the SARB has very little room for manoeuvre; if the oil price moves towards USD60/bbl or the currency weakens, CPI could average above 6.0% to the end of Q3:17 – as they have conservatively anticipated in their latest outlook.

We also think the SARB is mindful of global inflation, and the effect rising global inflation may have on the exchange rate pass-through (ERPT).

The challenge for the SARB (and central banks globally) will be how to deal with increased levels of uncertainty with respect to US policy and Brexit, and consequently developed market asset prices, and the spill-over effects for EM flows and EM asset prices, especially currencies. The SARB has expressed their apprehension and warned that while they feel SA is close to the end of a rate hiking cycle, the sensitivity of the ZAR to the US is of concern. We also anticipate that the sensitivity of the ZAR with respect to commodity prices and uncertainty surrounding their outlook will be of concern.

Pressure to hike

- If the Fed starts to hike, pressure may also mount for the SARB to hike. The SARB’s response to this question is consistent – that it does not track the Fed and that it has already raised rates 200 bps, while the Fed has only raised by 50 bps.
Market pressure should theoretically be placed on the SARB to maintain the real interest rate spread. We show in Figure 26 that even if the Fed hikes by 75 bps in 2017 and the SARB leaves rates unchanged at 7.0%, the spread of SA’s real rate over the US Fed funds real rate (using spot CPI forecasts) would rise from 1.3% currently to 2.2% by the end of the year. This is because the SA real repo rate is expected rise from 0.2% to 1.5%, and the US Fed funds real rate is expected to rise from -1.1% to -0.7% (this assumes US CPI rises to 2.0% by year end from 1.6% currently).

- **Higher than expected oil price**: We believe the SARB will look through first round effects from a higher oil price and wait for it to manifest in second-round effects.

- **Domestic political noise resulting in a weaker currency**: The currency is vulnerable to extreme political noise involving further attempts to capture the Treasury.

**Figure 26: SA’s real repo rate spread over the real Fed funds rate**

Source: Bloomberg, Standard Bank Research

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**Pressure to cut**

- **Weak growth**: If the cyclical upswing in growth plays out as we expect in 2017, pressure to cut in support of growth will diminish.

- **Lower structural inflation**: The SARB has emphasised lower structural inflation risks specifically risks emanating from wage inflation. Real wages have declined and the latest BER survey shows a fall in the inflation expectations of labour unions (Figure 27). Although labour unions may raise their inflation expectations by the time the next survey is completed for Q1:17, they are fragmented and far less powerful than they were during the commodity price boom. The market’s inflation expectations have also moderated, according to the 5Y break-even inflation (Figure 28).

- **Cyclically lower inflation**: Despite upward revisions to the near term inflation forecast due to higher oil prices as well as sticky food inflation, SA is still near if not at a peak in inflation and recent rains, base effects and weak domestic demand should allow CPI to slow towards 5.5% by year-end.

- **Resilient ZAR**: In addition, the currency has become a lot more resilient to political noise, and much of the ongoing battle for power is within market expectations.
Pressure for the SARB to move in both directions is a symptom of shallow cycles

We highlight how long and shallow the 2014-2016 inflation and rate hiking cycles have been, relative to history, in Figure 29. We expect this will continue in 2017 and that it should remain the case for as long as global inflation remains historically low and below targets. In this respect, we note that US inflation at 1.6% y/y is still below the Fed’s target of 2.0%. Shallow inflation and interest rate cycles translate into shallow growth and earnings cycles, and we expect this will characterise the recovery in SA over the next 18 months.
Figure 30: We anticipate that the inflation differential between SA and the US should fall in 2017, which should place less pressure on SA rates.

Table 2: Commodity price assumptions for 2017 and 2018

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Q1:16</th>
<th>Q1:17</th>
<th>Q2:17</th>
<th>Q3:17</th>
<th>Q4:17</th>
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<th>2017</th>
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Table 3: Macroeconomics forecasts

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<td>1.3</td>
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<td>-0.5</td>
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<td>-5.4</td>
<td>-3</td>
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<td>-1.7</td>
<td>-1.2</td>
<td>-4.2</td>
<td>-1.9</td>
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<tr>
<td>Gross domestic expenditure</td>
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<td>0.8</td>
<td>-0.5</td>
<td>-0.3</td>
<td>0.7</td>
<td>-1</td>
<td>0.1</td>
<td>-0.5</td>
<td>0.1</td>
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<td>Exports</td>
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<td>-4.5</td>
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<td>5.7</td>
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<td>Imports</td>
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<td>-4.2</td>
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<td>-2.6</td>
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<td>-0.7</td>
<td>-1.2</td>
<td>-4</td>
<td>-1.4</td>
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<tr>
<td>Current Account Balance % of GDP</td>
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<td>-3.9</td>
<td>-4.2</td>
<td>-0.5</td>
<td>-2.3</td>
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<td>-2.3</td>
<td>-2.6</td>
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<tr>
<td>Prices</td>
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<td>5.9</td>
<td>5.8</td>
<td>5.6</td>
<td>6.6</td>
<td>6.6</td>
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<td>6.6</td>
<td>5.9</td>
<td>5.7</td>
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<tr>
<td>Interest rates (%)</td>
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<td>10.5</td>
<td>10.5</td>
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<td>10.5</td>
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<td>Prime lending rate (end period)</td>
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<td>Platinum ($/oz)</td>
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<tr>
<td>Palladium ($/oz)</td>
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<td>568</td>
<td>679</td>
<td>684</td>
<td>700</td>
<td>750</td>
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<td>700</td>
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<tr>
<td>Copper ($/mt)</td>
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<td>4728</td>
<td>4793</td>
<td>5291</td>
<td>5868</td>
<td>5500</td>
<td>5500</td>
<td>5500</td>
<td>4870</td>
<td>5592</td>
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<tr>
<td>Brent ($/bbbl)</td>
<td>34</td>
<td>47</td>
<td>47</td>
<td>51</td>
<td>55</td>
<td>55</td>
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</table>

Source: SARB, Standard Bank Research
Rand may surprise in 2017 – broadly sideways to marginally stronger

We still expect the rand to approach 13.00 against the dollar

Our view is still that rand weakness will fade, based on the underlying fundamentals. We define rand weakness on approach of 14.00 – 14.50. As base case we still expect the rand to move closer to 13.00 against the dollar. At this stage we pencil this level in closer to year-end, but the currency may well move there earlier.

The rand remains well behaved, in line with our expectations

We continue to believe the rand is undervalued based on underlying economic fundamentals including inflation, growth, and interest rate differentials. We note that since H2:15, based on fundamentals, the rand has been trading between R0.70 and R2.70 higher than it should (Figures 31 and 32). The PPP-type model suggests that the currency should have traded closer to 12.50 during December 2016 than the 13.70 we saw. We believe that most of this risk premium can be attributed to country-specific risks.

The long-term trend support for the USDZAR, dating back to 2011, comes in at around 13.40/13.50 (Figure 33). If this support should give for an extended period, the USDZAR may well push lower, towards 12.50. This would be a momentum trade, similar to the one seen in the GBP early October (Figure 34). On the balance of probabilities, given lingering risks, our base case is that resistance at 13.40/13.50 will hold in early 2017.
At the same time, on the back of expectations of higher growth in the US, commodity prices have turned higher.

The rand remains a commodity currency and growth optimism has also seen commodity prices move higher. This should support the rand in an environment where US rates are expected to increase.

This is especially the case for metals and bulk commodities – South Africa’s major exports – as indicated by the CRB metals and raw commodities indices (Figures 35 and 36).

Although oil, which is South Africa’s single largest import, is also higher, there is generally a linear negative relationship between higher oil prices and the USDZAR over the medium term (Figure 37). The current linear relationship has been in place since 2015 and suggests that with Brent crude placed around $55/bbl, the USDZAR should be closer to 13.00 than 14.00.
We won’t argue that a higher oil in the long run is negative for the rand from a trade balance perspective but, as long as it goes alongside a rise in other commodity prices (as we have seen), the impact is mitigated.

An additional benefit is the possibility that higher commodity prices may see corporate income tax surprise on the upside, compared to expectations six months ago

Tax payments by the mining and quarrying sector (including metals) has diminished in share of total corporate tax payments

The relationship between tax payments in the mining and quarrying sector and commodity prices can easily be seen in Figure 39. The CRB metals index closely tracks the growth in mining and quarrying tax payments. This is encouraging as it is likely to see tax payments increase accordingly on the back of corporate income tax collection in the mining and quarrying sector.

Corporate income tax (CIT) revenue collection has, for the fiscal year up to November, shown growth of 4.1% y/y. This is already faster than growth seen in 2015/16 (over the same period) and may accelerate even further on higher commodity prices.
The 2016 MTBPS puts CIT revenue growth estimates for the current fiscal year at 5.2% y/y. This we believe is likely to be reached now (and maybe even slightly overshoot) on higher commodity prices and the fact that seasonally, CIT revenue collection picks up in any case in the final quarter of the fiscal year.

**Figure 40: Revenue collection – YTD (% y/y)**

![Revenue collection chart](chart.png)

Source: National Treasury

Inflation set to peak as rand finds support, providing for further tightening in real terms – which is in turn rand-positive

Support for the rand, despite a higher oil price, would put the peak in South African inflation behind us. We continue to see inflation moving lower from here, falling back into the target band in Q2:17, after peaking in Q1:17, and remaining within the target band for the rest of 2017. We expect inflation to average 6.0% y/y in 2017.

Fed policy impact on South Africa will depend on the growth outlook which goes alongside Fed hikes

Alongside higher inflation expectations, especially in the US, and the possibility of a US rate hike, we note that South Africa’s bond spread over that of the US doesn’t necessarily need to rise.

Alongside higher inflation expectations, especially in the US, and the possibility of a US rate hike, we note that South Africa’s bond spread over that of the US doesn’t necessarily need to rise.

The EMBI spread compressed during the previous Fed hiking cycle, while a longer time series of South African 10-year spread to the US also indicates that there is no consistent reaction to US policy tightening. Once again, what is important in our view is that the Fed hiking cycle will have to go alongside higher global growth for spreads to remain steady or decline rather than rise. The worst outcome would be a stagflation environment in the US where growth slows, but accelerating inflation forces the Fed to hike.
How we interpret local bond yields in terms of US bond yields

In our report “Closing the Nene-gap” dated 7 December 2016 we argued that South Africa’s country spread over the US could revert to the mean of 575 bps since 2009 irrespective of rating actions as spread compression is not only a function of credit risk, but also inflation risk (which, arguably, dominates in local bond yields). Since December, the spread has compressed marginally from around 645 bps to the current 630 bps. We continue to believe some compression of around 50 bps is possible. While foreign interest in EM bonds may decline, we continue to believe that South Africa is better placed to withstand foreign selling mainly because local assets under management is far greater than most of South Africa’s peers, arguably making the South African bond market more resilient than most as long as locals are willing to buy SAGBs. This of course will to a large degree depend on inflation and, by implication, the rand.

The Nene-gap

The spread between the US 10-year bond yield and that of South Africa has widened substantially since 2013, with pressure on South Africa’s bond yields initially triggered by the Taper Tantrums in 2013 and then again in Q2:15 on a rising probability that the US Fed might hike rates. The move higher in domestic yields was compounded by idiosyncratic risk – specifically the removal of then Finance Minister Nene in December 2015 (Figure 43). Although, during the course of 2016, the spread has narrowed again, it is still at 650 bps – almost 100 bps wider than the average since 2001 of 550
bps when inflation targeting was implemented and around 75 bps wider than the average spread since 2009 of 575 bps.

The important question is whether South Africa can remove the Nene-premium despite the fact that South Africa’s creditworthiness, both on the local and foreign currency front, deteriorated in recent months, according to the major rating agencies. We believe so.

**Peers managed to revert to averages despite a rise in risk**

We take a look at how South African peers have performed relative to the US. Specifically, we look at Brazil, Turkey, Russia, Indonesia, Mexico and Colombia. All of these countries currently have a 5-year USD CDS that’s trading high relative to the respective foreign currency rating by S&P (Figure 45). Some countries, such as Brazil, Russia and Turkey, have experienced ratings downgrades to non-investment grade in recent years by one or more rating agency, while the likes of Indonesia and Mexico have seen an improvement in their foreign currency rating.

**Figure 45: 5-year USD CDS vs. country risk**

![Diagram showing 5-year USD CDS vs. country risk](chart.png)

Similar to South Africa, all six countries under discussion moved from a position where their 10-year domestic bond spreads (relative to the US) traded well below the average spread since 2009, before the Taper Tantrums of 2013, to a position where spreads were trading well above the average by the start of 2016.
The country spreads for Russia, Brazil, Indonesia and Colombia peaked in either 2015 or 2016, and has subsequently returned to their average levels, irrespective of whether a country has seen an improvement in its foreign currency rating such as Colombia and Indonesia, or whether it has seen deterioration such as Russia and Brazil (Figures 46 to 49).

As always, there are exceptions; in this case, Mexico (upgraded by rating agencies) and Turkey (downgraded by rating agencies). Both countries, irrespective of their rating actions, have seen the spread relative to the US blow out in recent months. But we believe that this was due to very specific circumstances, such as the US presidential election in the case of Mexico, and the political purge in Turkey in recent months (Figures 50 and 51).
Closing the Nene-gap

Clearly, a country’s bond spread can compress to average levels, no matter which way credit ratings went. Spread compression is therefore not only a function of credit risk, but also inflation risk (which, arguably, dominates in local bond yields).

Looking at the recent developments in Mexico and Turkey (and, earlier, Brazil and Russia), the political landscape matters, and it is a key driver of idiosyncratic risk, currency weakness and, ultimately, inflation.

For South Africa, we believe that although the political landscape will remain in flux, 2017 will be less uncertain than 2016; i.e. the momentum is positive. This, in our view, would be one factor (amongst others) driving a more stable rand in 2017, compared to what we’ve witnessed since 2015.

South African bond yields, if US yields rise

Firstly, if politics in South Africa become less uncertain and inflation indeed peaks in November, then we see little reason why South Africa’s country spread cannot compress closer to the average since 2009 of 575 bps. Brazil, Russia, Colombia and Indonesia have done this – South Africa could do the same.
Secondly, the absolute value of South Africa’s 10-year bond yield would of course depend on where the US 10-year bond yield is. With a US 10-year bond yield at say 2.50% and South Africa manage to close the Nene-gap, it would put South Africa’s bond yield (eventually) at 8.35%. Likewise, a US 10-year bond yield at 3% will put South Africa’s 10-year yield (eventually) at 8.85%.

Thirdly, irrespective of where the US 10-year bond yield is, and is going, we believe that given a lack of compression in South Africa’s country spread relative to many of its peers, combined with a more stable rand, South African bonds may outperform peers.

This implies an even flatter curve first via a bull curve flattening

The SA 10y/2y slope is already quite flat, with the spread below 100 bps (Figure 54). But it may flatten even further.

Assuming that the SARB keeps rates on hold in 2017 (our base case), combined with the fact that the front-end of the curve (R203) is only 25 bps above 3m JIBAR and the 10-year bond yield (R186) could potentially compress 75 bps, the curve is likely to flatten.

Eventually, once there is more certainty on whether the next move by the SARB is indeed a cut (also our base case), and the market actually starts pricing a cut, it will provide further upside for bonds, although we would expect some bull-curve steepening when this happens.

Figure 54: SA 10yr-2yr spread

Our strategy

We still favour bonds in 2017, with potential upside for the R186 towards 8.10% – 8.30%. There is of course the possibility that the US 10-year bond yield could move to 3% (rather than stabilise between 2.30% and 2.50% in the medium term), which ultimately may put the R186 at 8.85% (assuming eventual mean-reversion of the country spread). We therefore would refrain from increasing exposure from levels close to 8.85%. While there may be value already, from a risk-return perspective anything above 9% is worth at least a look.
**Table 4: Currency forecasts (period end)**

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<tr>
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<th>Q1 17</th>
<th>Q2 17</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
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Source: Standard Bank Research

**Table 5: SAGB forecasts (period end)**

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Source: Standard Bank Research
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