GUEST BLOGGERS

South Africa's Sporting and Economic Scorecard

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Dubbed the “rainbow nation” after the end of apartheid in 1994, South Africa had much to be hopeful about. In 2010, it achieved heightened recognition among investors when it became the fifth member of the “BRICS” grouping of emerging market economies, along with Brazil, Russia, India and China. While its economy and demographics differ from other BRIC countries, it has one thing in common with Brazil, Russia and China: It has hosted major global sporting events over the years. South Africa hosted the FIFA World Cup five years ago, and it hosted—and won—the Rugby World Cup 20 years ago. Similar to sports teams, promising economies sometimes fail to play to their full potential, and South Africa’s economy has seen some struggles in the past few years. I’ve invited Johan Meyer, our senior vice president and managing director, South Africa, based in Cape Town, to share some of his insights on the challenges and opportunities facing South Africa today.

Sport is a national obsession in South Africa, and many observers have noted that the international sporting boycott of South Africa in the 1970s and 1980s played a pivotal role in bringing apartheid to an end. For many people in South Africa, the symbol that the hated apartheid era was finally over was when newly installed president Nelson Mandela, wearing a Springbok jersey, handed the Rugby World Cup to the captain of the country’s winning team.

This year marks the 20th anniversary of that momentous event, and while South Africa’s progress in this year’s Rugby World Cup might be more precarious, overstating the importance of sport in the country remains difficult. South Africa has gone on to host a number of international sporting events including the Cricket World Cup, along with Kenya and Zimbabwe, in 2003, and the FIFA World Cup in 2010.

New and refurbished infrastructure in terms of stadiums, transportation and accommodations created numerous employment opportunities and developed expertise and invaluable experience in hosting these world-class events. These events showcased South Africa’s ability to organise and host huge events on the world stage. In addition, it exposed the many wonderful aspects of the country to an international audience that would not otherwise have paid much attention to South Africa. The lasting legacy of these sorts of events in terms of the economy has been more on the side of tourism opportunities. Cape Town, for example, is a true world-class destination with many alluring features, including natural beauty, fine dining and even adventure sports.

Getting Growth Back on Track

South Africa’s gross domestic product (GDP) growth is projected at 1.5% this year, steady with 1.5% in 2014.[1] While this figure is positive, we think the country has the elements and the potential to grow its economy at an even higher rate. An electricity crisis is one factor that has stunted growth this year, as controlled power cuts and outages to relieve pressure on the grid have curbed productive activity, particularly in industry.

South Africa and its neighbours (including Namibia—a fellow Rugby World Cup participant this year) are rich in natural resources such as gold, diamonds and even uranium. In South Africa specifically, the mining sector represented 8.3% of 2013 GDP in nominal terms, with primary mineral exports at 22.7% of total exports.[2] The sector is clearly critical to the overall health of the country's economy. In recent years, however, the industry has been hamstrung by the lack of capacity in terms of electricity production and aging infrastructure at many of the mines, which has added to costs. In times of lower commodity prices, companies look to manage costs, so there tends to be a significant focus on efficiency. Also, some mining assets simply become unsustainable in lower-price environments, so unfortunately, there is pressure on the employment level.

Without a doubt, we see the stubbornly high unemployment level (at about 25%) as the most significant challenge South Africa currently faces and a major obstacle to improving the quality of life for a large portion of the population. At the same time, the tax receipt base is under pressure as a result of lower corporate profits, so the burden shifts more toward income and consumption tax to fund the government's various support programs like child and old-age grants.

Given the slowdown that we are seeing in the commodity space, many companies involved in this area are hard pressed to manage costs, resulting in further negative implications for employment. In my view, it is absolutely critical that the government, labour unions and employers work together to create a more flexible labour environment that is not as fixated on high entry-level wages, but rather, is focused on improving the overall level of employment.

In my opinion, South Africa's leaders need to take note of constructive criticism and be more willing to acknowledge and rectify mistakes. A key case in point would be the visa regulations that have been introduced recently. Visitors from important tourist markets like China now have to apply for visas in person to have biometric data captured, which makes the process time consuming and expensive, especially if the prospective visitors have to travel long distances to visa processing centers. In addition, families traveling with children need to have unabridged birth certificates in addition to passports for the children, a rule enacted this year to help prevent child trafficking on the continent but one that adds a further layer of complexity and bureaucracy for tourists. At a time when the weaker South African currency (the rand) should make South Africa a really attractive tourist destination for international visitors, the country is actually experiencing a decline in the number of visitors.

Weathering Market Volatility

South Africa's stock market has been performing fairly well this year (up 5.6% year-to-date[3]) in light of recent global market volatility and despite weak internal fundamentals. Looking at the companies that have had good share price performances in recent months, we have seen one relatively common theme: offshore exposure of the underlying operations. As the South African rand has trended lower against the US dollar and other major currencies, the contribution from non-South African operations became more meaningful and therefore translated into a hedge against the currency movements to a certain extent. That, coupled with generally strong balance sheets and strong management teams, made South African investments more attractive to many investors, compared to the situation in Brazil for example, in which the markets have been extremely volatile.

South Africa has been spared the recent global market volatility to a large extent, in spite of the substantial weakening of the rand relative to the US dollar and other major trading currencies. The recent decline in oil prices has proved to be a massive boon in terms of limiting the impact of inflation in South Africa. Consumer spending has been relatively resilient, especially among the higher income groups. Those people who are gainfully employed are typically getting wage increases in excess of the overall inflation rate, so this tends to translate into higher spending. We have seen a slowdown in the purchases of consumer durables such as new vehicles, as financing becomes more onerous on the back of higher interest rates. But we think some of this is likely to have a short-term positive effect on consumer non-durables. Looking at the corporates, we have found companies in South Africa tend to be conservatively managed and rarely have high debt levels, so we think the prospect of a further increase in interest rates is unlikely to have a major impact on the financials of local companies.

The Impact of Oil Prices in Africa

Turning to other areas of the continent, African markets that import oil-related products—Kenya, for example—will likely have experienced lower inflationary pressures thanks to the drop in the international price of oil. At the same time, foreign exchange earnings in Kenya have come under pressure from lower tourism numbers, due to safety concerns and a decline in some main exports such as coffee. Overall, the fiscal situation in Kenya still looks relatively benign to us with the central bank taking a more measured approach to interest-rate hikes compared to the last cycle, when consumers and corporates alike were surprised by the rapid and severe hike in rates.

For oil exporters in Africa such as Nigeria and Angola, it is a different story. Lower oil prices have seen foreign exchange earnings slashed, and governments will have to deal with ballooning budget deficits in the current price environment. Nigeria is specifically trying to defend its currency but is finding it increasingly difficult to do so. Investor confidence has also taken a hit due to President Buhari's long delay in announcing his cabinet. This situation has, however, created some interesting opportunities in consumer and banking names in Nigeria that are now trading at what we view as attractive valuations. Of course, there will likely be more short-term pain, but given favorable demographics and the potential to generate higher levels of overall wealth over the longer term, Nigeria remains an exciting market for us.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets.

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1. Source: Statistics South Africa. There is no assurance that any estimate or forecast will be realized.

2. Source: Chamber of Mines of South Africa, Facts & Figures 2013/2014.

3. Source: FTSE JSE All-Shares Index; Bloomberg LP, Johannesburg Stock Exchange. As of October 7, 2015. Indexes are unmanaged, and one cannot directly invest in an index. Past performance is no guarantee of future results. See www.franklintempletondatasources.com for additional data provider information.