PERSPECTIVE

South Africa: Political and Investment View

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South Africa's ruling African National Congress party maintained its power, winning the national elections this month. But can the country's leaders stamp out corruption, and spur more robust economic growth? Franklin Templeton Emerging Markets Equity's Danesh Ranchhod shares the team's view on the election and the implications for investors.

South Africa has just completed its 6th democratic national elections and saw a majority win of 57.5% by the ruling party, the African National Congress (ANC).

The result is considered a respectable win for a party that has been accused of rampant corruption, weak economic growth, poor state-owned entity management and a policy stall. Much of the malaise has taken place under the leadership of the previous president, Jacob Zuma.

There was renewed optimism when Zuma was replaced as country president with Cyril Ramaphosa in January 2018 after the ANC's own party elections. However, Ramaphosa was still dealing with Zuma faction members within the ANC. So, reforms seemed slow though the overall direction seems to have improved. It is now hoped that the ANC's national election win gives Ramaphosa the political mandate and power to better execute on key reforms. Opposition parties still remain relatively small, and provincially the ANC has managed to dominate in 8 out of 9 provinces.

With elections now behind, many observers will be looking to the cabinet review at the end of May as a first indication of how the president will be dealing with compromised ministers.

A Favorable Start to Stamping Out Corruption

Corruption has become quite pervasive at all state levels under Zuma, so any action Ramaphosa can take to address this meaningfully within the party and state-owned entities will be considered a key progress marker. In what seems a favorable start, he has recently appointed a new head of the National Prosecuting Authority, who is well regarded with strong credentials.

We think the next test will be how the ANC can tackle policy direction. There remains confusion around key policies on the mining charter, land nationalization and the much-delayed issuance of spectrum to the mobile telecommunication companies.

There is also the matter of the state-owned entities that need financial and operational assistance, the biggest of which is the electricity utility, Eskom.

With respect to the economy, it remains weak. Gross domestic product (GDP) growth in 2019 and 2020 is forecast at 1.2% and 1.5%, respectively.[1] This muted growth can be closely linked to the problems discussed previously. In the near term, there remain few catalysts to drive growth, with headwinds from a pressured consumer, weak business confidence and high unemployment.

In our view, the path to changing the current status quo will be clear execution of reform, which should then translate into increased confidence and improved investment.

Historically, South Africa has recovered from recessions or low-growth environments with an increase in government spending first, with the private sector following. This is the trajectory we think is likely to occur going forward for South Africa, assuming reforms are meaningful enough to increase confidence.

South Africa's elections have not had much impact on asset prices currently. The South African currency, the rand, has been trading close to fair value based on inflation differentials. We anticipate it should likely continue to trade around current levels, outside of any global impacts, with some potential for improvement if the market gains more confidence amid positive political momentum.

Ten-year local bond yields are currently offering just over 9%, implying some of the highest real returns seen in South Africa.[2] This excess real return is factoring in fiscal risk given constrained fiscal revenue growth and a relatively higher debt/GDP ratio as well as leverage problems the state-owned electricity utility is facing.

South Africa's stock market is considered inexpensive on a historical basis, reflecting the consensus for weaker growth expectations in the near term. Currently, the MSCI South Africa index (excluding Naspers) is trading at roughly 12x 1-year consensus forward earnings, which is one of the lower valuation points seen in the past four years.[3]

Currently, we are finding some opportunities in select retailers and banks that have a self-help thesis in margin expansion and market share gains. While there is no shortage of what we view as quality companies with solid management in South Africa, earnings growth has been muted given the weak macro framework. In the interim, we are keeping a watchful eye on key reforms needed to drive overall fundamental growth in South Africa.

Important Legal Information

What Are the Risks?

All investments involve risks, including the possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. 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. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

1. Source: International Monetary Fund World Economic Outlook database, April 2019. There is no assurance that any estimate, forecast or projection will be realized.

2. Source: Organisation for Economic Co-operation and Development, data as of May 16, 2019.

3. Source: MSCI Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. There is no assurance that any estimate, forecast or projection will be realized. Past performance is not an indicator or guarantee of future results.