

South Africa: The risk narrative for 2017

Overarching politics will be complex

2017 outlook: We expect the marked divergence to continue between what asset prices can do and what goes on in terms of macroeconomics, risk events and politics. Put simply, we expect some recovery in headline real GDP growth, albeit still shrinking per capita income growth, with the ANC elective conference dominating throughout the year to December. However, with South Africa looking somewhat better than peers such as Turkey, we believe asset prices and ZAR especially can do 'ok' until potential downgrades come – the timing of which remains uncertain, if still on the horizon.

Forecast overview

Are we bullish or bearish for 2017? This is a difficult question. We are only marginally below consensus forecasts for the coming two years on growth (though below official estimates marginally); we are roughly in line with them on CPI inflation (though above the SARB). That might be described as fairly neutral.

However, in 2016 the market appeared to define a narrative of “off the bottom” as being positive because we have passed the worst of the height of the Nene-gate impact on the economy. We think this is true – and the economy showed its resilience by not going into recession in 2016 despite all the political negativity – as we forecast a year ago. We think in 2017 the key investor question will be “what are the drivers of growth?” We think the answer is likely to be a very loud in 2017: “not much at all”. Indeed, in 2017 we believe the market will become more disappointed about the reforms already proposed and the lack of meaningful new ones forthcoming. Political constraints on government in this area may become more obvious as growth remains low in absolute terms and vs peers and as unemployment grinds higher as the level of employment grows far too slowly to absorb the bulging labour force. The negative effects of a national minimum wage should start to appear, although in our opinion, these will only become evident in the years after as data and studies emerge. Overall, we think negative per capita income growth and negative TFP growth will be the ‘low lights’ of the year in data terms. Looking at it in this way, we are not off the bottom and real incomes are still falling. The market should be more sceptical of official spin on such matters in 2017.

We expect politics to remain very noisy, but the market has largely become bored of attempting to follow the intricacies of the ANC's internal machinations. We think the markets will still overplay the tail risk of Zuma, even though this seems highly unlikely before the December elective conference. In our opinion, internal compromises keeping Jacob Zuma in office after the November ANC NEC meeting will prevent PGxit; however, we believe there is a meaningful (if difficult to pin down) likelihood of a wider reshuffle that could shock the market.

South Africa however is not as dramatic a risk case at all vs peers and especially Turkey for 2016. Hence, we see South Africa outperforming Turkey at least in H1 2017 or longer if the TCMB's credibility does not recover. If Turkey overcomes its current obstacle to the executive Presidency by mid-year this should allow the market to focus more on South Africa politics in the region in H2 in the run-up to the ANC elective conference in December.

Broadly, we see more of a magnified focus on EM under a Trump Presidency with the prospect of higher US policy rates and a stronger USD, which should weigh on South Africa as a dual-deficit country, albeit maybe less so than some of its peers. We see little meaningful upside of US policy on US growth in 2017 and hence are unable to be over-

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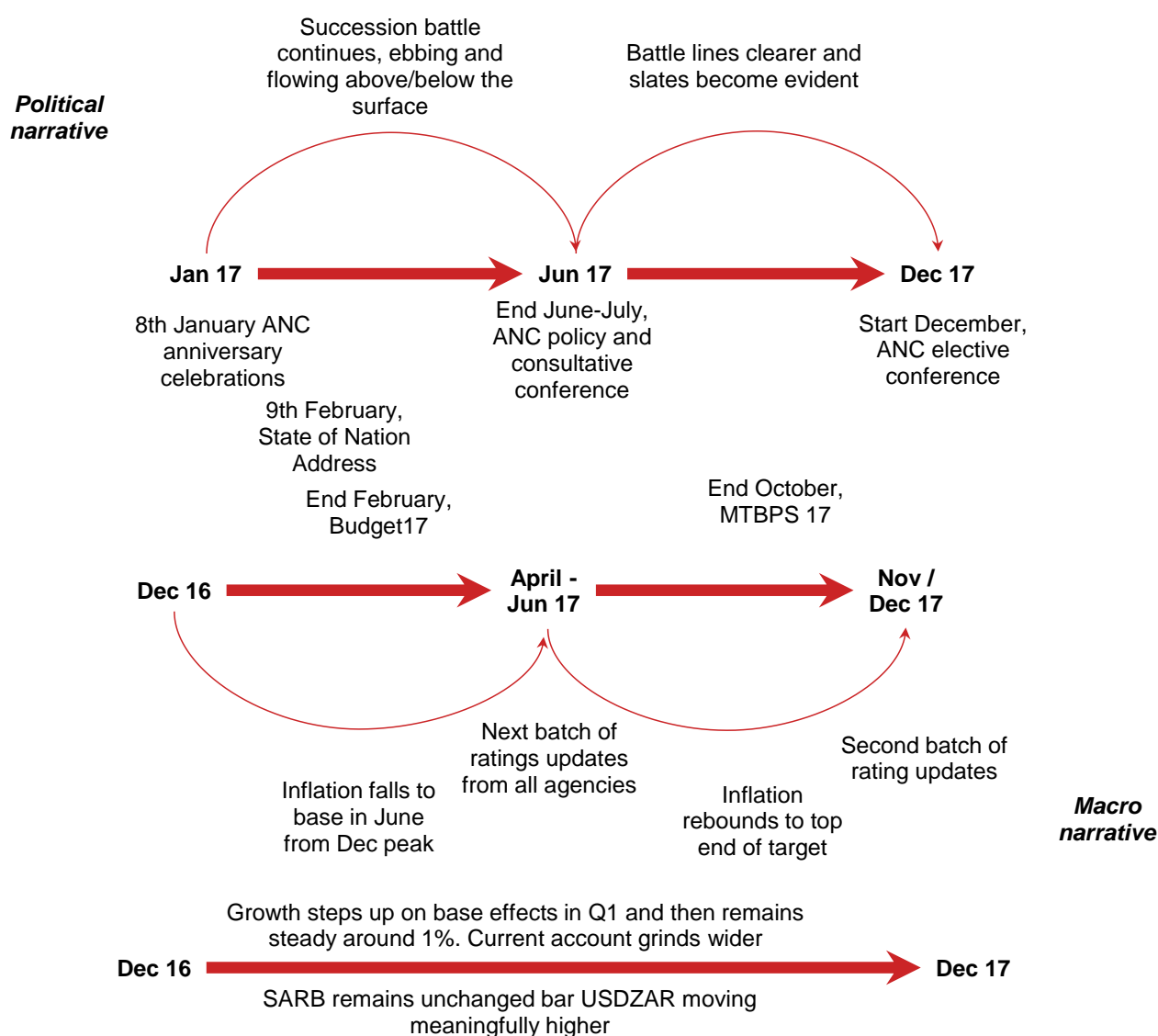
enthusiastic about it and the positive effects on South Africa, especially with a weaker Asia and prospects of US protectionism. The real unknown for 2017 is if South Africa's yield offering – which since the US elections has provided adequate compensation – will still be protective enough. We think the curve may have to steepen somewhat, but again can outperform peers.

Ratings again will be an important factor wrapping together medium run growth and fiscal risks as well as the noise from parastatals. Indeed the ebb and flow of events around Eskom, particularly with regard to the issues of contingent liabilities and its nuclear build programme will dominate again.

In summary, with inflation likely to move lower (but less dramatically than expected by the market previously), growth grinding slightly higher and the labour market stabilising at a (very) weak level, 2017 might be described as 'ok', but from a developmental and inequality perspective will not be positive and result in another challenging year.

Risk timeline

Fig. 1: 2017 narrative map



Source: Nomura

Putting all this together we see several broad sweeps of risk narrative:

- Political from President Zuma consolidating at the **8 January** ANC anniversary celebrations through to the elective conference at the **start of December** via the end **June/start July** ANC policy and consultative conference. The **9 February** State of the Nation Address from President Zuma, as in previous years, will be an important marker. We then see reshuffle risk through **end**

January and start February. We also need to keep a continual watch on ANC splits within parliament.

- A fiscal and ratings narrative arch encompassing the Budget expected in the **last week of February**, ratings updates to come between **April and June** (in a longer period than 2016 which saw the agencies more tightly bunched), the MTBPS in the **last week of October** and then further ratings updates at **end November and start December**.
- We see growth broadly constant through the year in y-o-y terms after a step-up in Q1 data out in **March**. Inflation should fall from a December peak (and rebase and reweight published) in **January** through to a bottom in June data out in **July** and then a rise back up to the top end of the SARB's target.
- We believe the SARB will be steady but hawkish throughout the year, ready to act on a weaker ZAR, higher inflation expectations or an unanchoring of the long end of the inflation forecast.
- Much of the event risk is hard to put on the calendar. For example, the raft of court cases against state institutions and political leadership by opposition parties and the Zuma 783 corruption charge appeals procedure. These narratives will grind on in the background with some regularity.

2016 forecast post-mortem (mea culpa)

It was certainly a dramatic year for forecasting, not made any easier for ourselves by our 19.0 USDZAR end-2016 forecast. Our 2016 outlook gave way rapidly to a post Nene-gate outlook and then another outlook after we upped our USDZAR view. Below, we look at how things ebbed and flowed from those points until now, and the shifts are enlightening.

The core of the forecast was correct for the year, which called for low growth and a lack of meaningful reform with high and sticky CPI inflation led by food prices that would lead to SARB hikes (and more than the market expected), ratings being a key focus and significant political noise. Within this there were marked divergences depending on the starting point taken.

CPI inflation and SARB forecasts ended up being not that dissimilar to our [2016 outlook](#) forecast published on 4 December 2015, [link] which saw FX strength in 2016, as we thought there would be some reverse of the previous negative trend in ZAR as the SARB hiked rates. However, growth ended up being significantly lower than that pre Nene-gate outlook, but also even after our post Nene-gate outlooks as the depth of the political and policy uncertainty shock really hit investments especially, but also into much lower real wage growth and onwards into consumption, even though net trade was more supportive and the SARB did not hike as much as expected. That said, we had continually highlighted the downside risks to growth.

Fig. 2: Forecast shifts

Forecast	2016 outlook		Post Nene-gate		Post ZAR piece		2017 outlook		
Publication date	4th Dec 15		21st Dec 15		12th Jan 16		5th January 2017		
Year	2016	2017	2016	2017	2016	2017	2016	2017	2018
GDP	1.6	2.2	0.9	1.8	0.9	1.8	0.5	1.0	1.6
CPI (average)	6.1	5.9	6.4	6.3	6.5	6.5	6.3	5.8	5.6
CPI (end period)	6.0	5.9	6.8	5.9	7.0	6.1	6.5	5.7	5.7
SARB	7.50	7.50	8.00	8.50	8.00	8.50	7.00	7.00	7.00
USDZAR	12.75	13.00	16.00	16.00	19.00	20.00	14.75	15.50	16.50

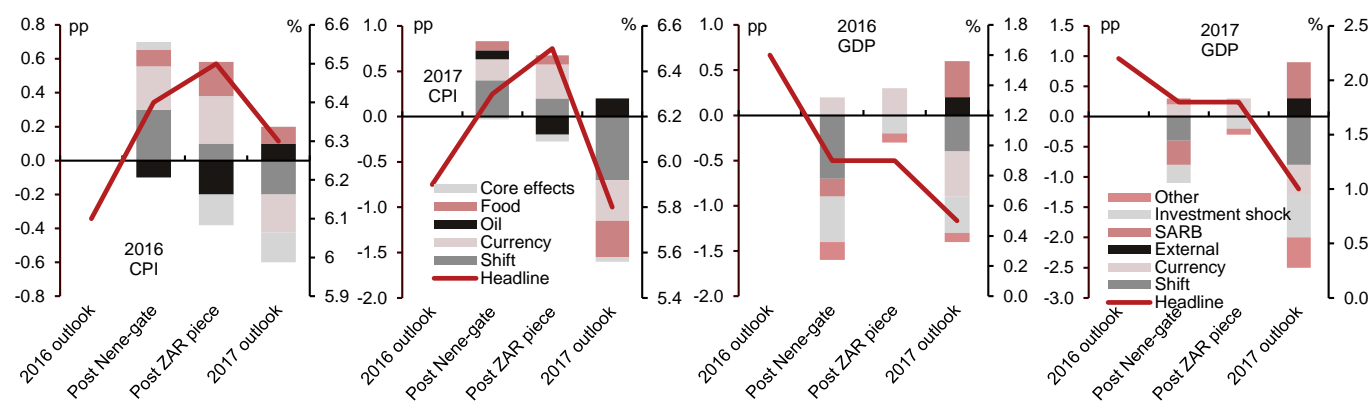
Source: Nomura

In this sense, our 19.0 USDZAR view was a distraction from the underlying story, and while quite clearly wrong, only ended up influencing our CPI inflation and in turn the SARB view. Hence, it was important that throughout the year we did on occasion publish 'flat-ZAR' forecasts for CPI inflation and developed our more layered SARB rates view, which highlighted no cuts to come and trigger levels for hikes which if they did not materialise would see the SARB stand still.

CPI inflation did not (net-net) materially surprise to the downside excluding these effects. Indeed, the flat ZAR view published in January after our 19.0 USDZAR piece put

average inflation for 2016 around 6.0% and at 5.5% for 2017 and they have pretty much remained there. Our forecasts now are 6.3% and 5.8%, respectively, which reflect higher oil prices into year-end and stickier food prices. Overall then, we think our CPI inflation model has behaved very well; the issue was the assumptions used. (Behind the scenes this is also reflected in the fact the model structure when it is re-estimated each month has not materially changed.)

Fig. 3: Forecast shift decomposition



Source: Nomura

From here we put in more SARB rate hikes on a higher inflation (and especially core) forecast. We do not regret such a move and it was internally consistent. In our opinion, what is interesting in 2016 was the slower nature of the SARB's hawkishness turning into hikes. As such, the SARB hiked less even than our pre Nene-gate 2016 outlook, where we saw rates going to a neutral 7.50% and then staying there through to 2017. As such, even if USDZAR had reached 19.0 the SARB may well not have raised rates to 8.50% in 2017, but instead say 8.00%. This is an interesting factor to consider and suggests slightly more weight on low growth than maybe we have seen meeting to meeting and the desire to sit just below neutral, which indeed feeds into our view of no cuts from here on the forecast horizon.

So where did the 19.0 USDZAR view come from that effectively blew up our CPI inflation and SARB view? The [original paper](#) in January set out a very clear econometric framework for considering where USDZAR would be based on REER estimates. It used PPP, idiosyncratic (relative) risk premia, a BEER and also looked at some bilateral issues vs China. We actually do not think there was much wrong with this analytical framework and the blame cannot be put there. Indeed, that paper set out several scenarios for ZAR in each model that included upside scenarios that would have taken USDZAR down to between 12.81 and 14.63 (from 16.67 on the day of publication). The framework had the answers.

It appears that the issue was the selection and construction of the scenarios into the final forecast. Put simply, they were driven by four Fed hikes still forecast at that time and a lack of EM carry rally for the year, which we spun into a narrative that South Africa politics and ratings issues would be a focus for the market and drive ZAR weaker through the year. If the market had focused on these factors and we had had that number of Fed hikes, rather than just one, we may well have ended up at 19.0. Overall, we have no particular regrets on making that forecast at that time.

But more fundamentally, we do regret it and the lesson to learn was we did not change our ZAR forecast fast enough in mid- to late-Q1 2016 as Fed rate hike potential rapidly fell away and the EM carry rally gained legs and momentum. While we did downwardly revise our forecast in several steps through the year to 14.75 most recently (a forecast from mid-November), we should have done it much earlier and more significantly (indeed referencing the more positive scenarios from the start of the year). We think this is ultimately the root cause of the (ZAR-related) headline forecast errors for 2016. We became wedded to a view that the politics and ratings narratives would ultimately burst through even an EM carry rally – which with hindsight was wrong. Instead, markets focused on the positives and skewed the narrative to fit the carry rally.

One headline forecast from after Nene-gate was that there was a significant probability of either PGxit or Zumxit. While we never called for either, we think given the events of

2016, how close we came before the last G20 meeting to PGxit and how close we came to Zumxit after the November ANC NEC meeting – that this forecast was correct.

Our (end-2015) forecast on the local elections was broadly correct that the ANC vote share held up nationally more than many would expect and what the polls were then predicting, but that we were wrong in that three metros fell to the opposition, whereas we only saw one transferring control.

Our ratings view for the year was wrong as we said one agency would be sub-investment grade by year-end. No ratings agencies are sub-investment grade, thanks to them giving South Africa the benefit of the doubt being on potential reforms and the hard work of National Treasury staff. That said, we were proven correct in that ratings risk was a key narrative for the year and our forecast has always been to highlight that it is more 'when not if' on this subject and hence the renewed focus for 2017.

We made a number of specific risk forecasts on Eskom's increasingly monopolistic mind-set, the nuclear generation issue and stresses on parastatals which have come through. We also highlighted 2016 as an important year for eyeing rent extraction and tenderpreneurship after Nene-gate which it certainly has been, even more than expected, as the Gupta saga has carried on through to the expose from the Public Protector's report.

Politics outlook for 2017

Politics will be the key overarching narrative of the year, in our view. It should segment the year into two broad sweeps – between the 8 January ANC celebrations and a likely 'regrouping' of the Zuma faction at that time, through to the policy and 'consultative' conference at end June/start July, and from there to the elective conference at the start of December.

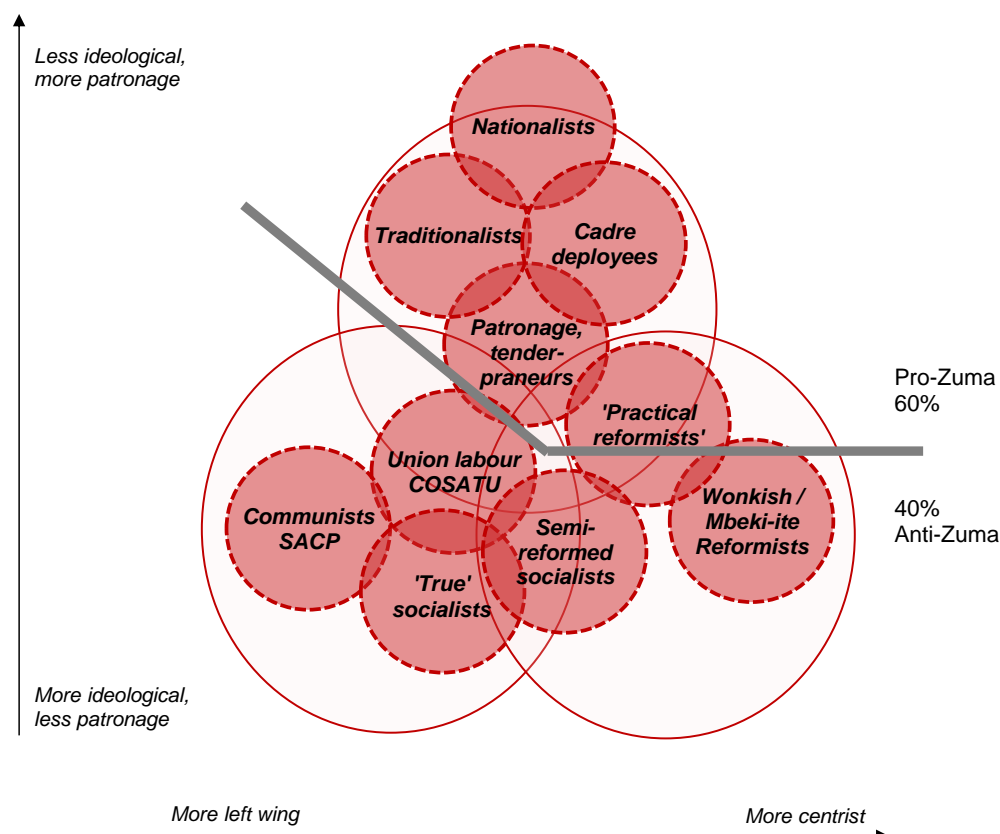
The political 'war' that is ongoing is likely to ebb and flow above and below the surface. In our opinion, the concern for the market is likely to be that the anti-Zuma camp's battle with Cyril Ramaphosa as a key candidate for the top job within that (though not the only one) will be fought largely in the open and as such is likely to draw significantly more attention from the media. The Zuma camp instead will likely fight its battle mainly on the ground and below the surface and as such, garner less media attention of the specifics of what are going on behind the scenes vs set pieces speeches and events undertaken by the other side. This could well lead to the risk of the market misunderstanding the true status of the two camps. If the market does overestimate the likelihood of a Cyril Ramaphosa victory, then it will be more supportive for the market through the year and equally a much greater likelihood of a market upset at year-end.

We think the Zuma camp could 'play dirty' in a way the anti-Zuma camp would be less inclined to. This will play to Zuma's ultimate skill, which is internal party management – seen most obviously at the last NEC meeting. As such a key but likely largely overlooked issue (by the market) in 2017 would be the ebb and flow of branch level structures – some get shut, others are opened, leadership at branch level gets cycled over, sometimes violently, provincial structures are brought to bear at the branch level. This is all ultimately because an elective conference (and indeed the policy conference) is an aggregation of the ANC at branch level. This is how the Zuma camp could win (and is why we think the most likely outcome is that they will). The elective conference (and key issues in the policy and consultative conferences) will not be decided by set piece speeches, media or other forum, instead it will be the personal gerrymandering of individual branch level votes.

It is important not to get too bogged down in the personalities. What is instead important is to recognise there are two camps – a status quo camp and a change camp that we term a "Zuma camp" and an "anti-Zuma camp", respectively. 2016 saw too many stereotypes of this as 'light' vs 'dark' and 'good' vs 'bad'. Such characterisations are often unhelpful and in 2017 are likely to be increasingly misleading. The reason for this is the subtlety of outcomes depending on different coalitions between a much richer tapestry of factions within the ANC that we outline in our traditional augmented bubble chart below.

In our view, the possibility of shifting makeup of coalitions will be important for policy and the ideological flavour of economic policy-making that will be important for the market and investors.

Fig. 4: ANC schematic – ‘The bubble chart’



Source: Nomura

What is not commonly understood is that the anti-Zuma camp (the camp looking for change), is arguably more left wing than the Zuma camp and the status quo faction. This is why, in our opinion, it is a bad idea for investors to simply see anything against Zuma as good and anything for it as bad. We attempt to outline this below and show how the 'practical reformers' (a group in the ANC that still understand patronage cannot be removed but want difficult reforms to allow the country to grow faster and ensure ANC success in 2019) are actually key marginal participants. We think this faction was key to Zuma retaining power at the recent NEC meeting and may well have made some deal with him at that time about their involvement through the elective conference. If they were to swap sides they would drag the anti-Zuma faction balance of view more towards the centre and the Zuma faction centre of gravity would shift leftwards slightly and perhaps more towards unfettered nationalism and other unsavoury parts of the ANC.

What we think investors don't fully understand is that the coalition of factions behind Cyril Ramaphosa is quite broad, but appears weighted quite heavily towards the left wing. Indeed, he himself has had to sound more left wing on issues such as transformation and the labour law issues to secure their backing. This is why we have long argued that a Ramaphosa Presidency is not some panacea for reform and high growth, even if it would be less corrupt at the margin. Hence, below we have outlined a "bumble along" scenario, where there is still a heavy power weighting to the left but generalised a broad mishmash of views.

The other reason not to focus just on personalities is that we are likely to end up with complex slates. While the ANC has attempted since the local elections to steer the party towards a 'one slate' model (which would be a broad coalition of acceptable faces across all factions), we do not believe such a common slate is possible. Indeed, we think after the last NEC meeting the idea has been largely abandoned. Nevertheless, the two slates emerging would each be complex coalitions, where we would monitor the centre of gravity of each and who is around a central presidential nomination. Again, this is where the 'location' of the 'practical reformers' is important and where there is the potential for an 'efficient rent extraction' upside scenario for the economy. The reality is likely to be that both anti and pro Zuma (change and status quo) slates are likely to resemble something more like the 'bumble along' scenario.

Fig. 5: Shifting power support

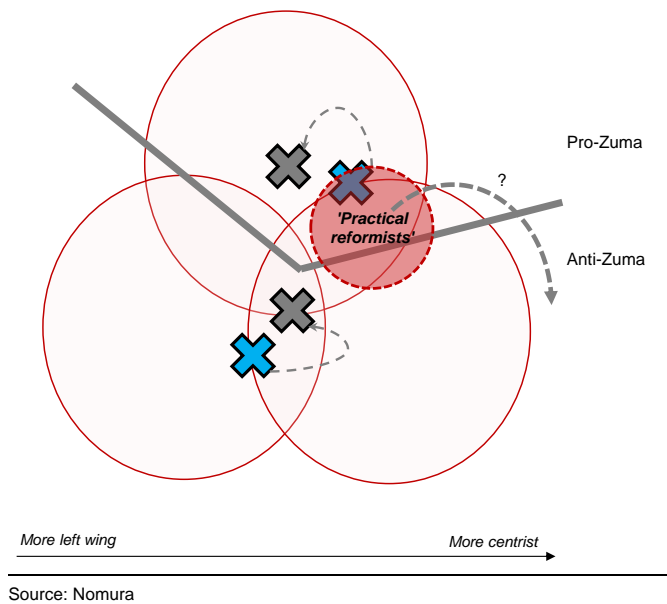
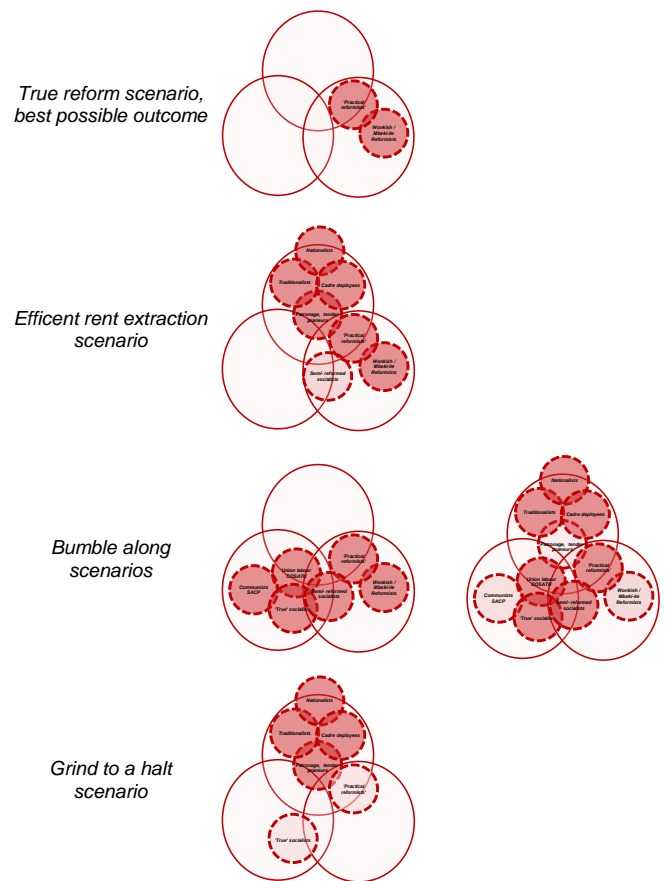


Fig. 6: Potential Political outcomes



These slates will likely be known during October and November, though official publication of the election details won't happen until shortly before the elective conference assuming the previous conference's logistics continue. However, we should have a better idea of how they are forming through various NEC meetings occurring each month and in particular through the fractures that become evident in the policy conference starting at the end of June. What is new this time is the 'consultative conference' between the ANC branches, leadership and ANC veterans that is occurring straight after the policy conference at the start of July (is the working assumption – there is some debate about this still and it may change timings). This may well see a much more open 'rehearsal' of the elective conference with factional coalitions and even slates seeming much more evident.

We should not underestimate the importance of the slate process and with it, NEC nominations and composition for the future of South Africa and indeed for the face of an ANC cabinet and policy after 2019.

Our current working assumption is that the Zuma camp has Nkosazana Dlamini-Zuma as its candidate and her profile is likely to be increasingly pushed in H1 as she returns home from her stint as head of the African Union. In our opinion, this camp is still not 100% set on her and seems uncertain about her potential success in the 2019 elections up against the DA's Mmusi Maimane, as well as the issue of her surname and not being a clean break from the Zuma era. A senior member of the so-called "Premier League" is also a possible alternative, with the Premier of Mpumalanga David Mabuza as one potential alternative option. We will monitor how he is profiled in H1 and what role he has at the NEC meetings and the mid-year conferences. The role that ANC Treasurer General Zweli Mkhize has in any slate or even as a potential (though less likely) option for the top job is also important to watch. We currently think he could be a 'powerful' Secretary General as one option. We think the candidacy of the current speaker of parliament, Baleka Mbete, is largely a distraction, and while she may well have a run at it, she could ultimately end up on a Zuma camp slate.

On the other side the candidacy of Cyril Ramaphosa is the only one publicly stated yet. However, other options on this side include current ANC Secretary General Gwede Mantashe for the top job or as a potential Deputy President. If Dr Mkhize switches sides,

we think this would be a pretty dramatic event if he appears on a 'change' slate in any position let alone the top job. Potential compromise candidates have also been discussed that could appear on this side, including current minister in the Presidency Jeff Radebe, who could be one to monitor. The possibility of a veteran taking over like previous Deputy President Kgalema Motlanthe has been raised, but we do not think he will get anywhere in 2017.

The ebb and flow of the battle will be seen by what these characters are up to and where they are slotting into. Even though obviously everything can change rapidly through the year, we still have as our baseline that a Dlamini-Zuma Presidency will emerge with a largely bumble along outcome on the wider slate and policy.

More immediate political issues

We see the market still overplaying President Zuma's constraints. It is true in our view that his survival at the last NEC meeting was premised on certain guarantees from his side that the removal of Pravin Gordhan would not occur (no PGxit), but wider than that we think a reshuffle and consolidation of power around him is still possible in the coming month or so. We recognise that such a reshuffle has basically been hanging over us for two years now, but the immediacy of the coming elective conference does change the political calculus somewhat. It will remain a likely but not "for certain" even in the near future, in our view.

We must also consider the risks of Zumxit in 2017. In 2016 we flagged this as a key risk, but to ultimately see the event itself as not a baseline. We think the probability that Jacob Zuma survives 2017 is actually higher than for 2016. His internal opposition has already shown revealed itself and we believe there is little new news against him that could decisively shift the balance – especially now (we believe) he has control over the Public Protector and retains full control over security structures (both the state's and ANC's).

We see the ANC caucus in parliament as a key source of uncertainty and risk with its leaders, Jackson Mthembu, a now vocal anti-Zuma figure and the possibility of a caucus split. We think President Zuma can hold the caucus together using a mixture of methods including security structures, but the likelihood of an anti-Zuma grouping-led no confidence vote from within the ANC caucus is a key risk to watch. That said, we think the opposition parties would be unlikely to support such a motion in order to highlight the dysfunction within the party.

Opposition parties should be less eventful for markets, though will likely start to build manifesto bases through H2 especially and this should be important for DA especially. Parliamentary noise may well continue from the EFF, but is less likely to be market-moving.

Student protests are likely to remain (possibly violent again), especially around the time of the State of the Nation address in February; however, their ability to become a market-moving event seems much lower now barring any major new concessions from the fiscus in 2017, which could result from the Fees Commission expected to report shortly.

We expect politics to remain very noisy in 2017 and playing out through NEC meetings, conferences, parastatals and state institutions – but holding back and distracting from any ability to undertake real policy change and still suppressing investment and sentiment in the economy to a degree.

Ratings

Moody's are set to publish reviews on 7 April, 11 August, 24 November; S&P on 2 June and 24 November and Fitch has not published ratings dates, but reviews are expected around May/June and November/December.

For us the medium-run issue on ratings has always been more if not when South Africa gets downgraded to sub-investment grade. Our view that it will be difficult to get back to meaningful positive per capita income growth, the political landscape and lack of reform have fed this view. 2016 taught us that ratings agencies are often ready to give more benefit of the doubt on reforms and find it too hard to take decisions at the edge of a junk rating on major medium-run issues such as where per capita income growth will be.

Ultimately, that benefit of the doubt could run out as unemployment is likely to continue to grind higher and a downgrade mid-year from Moody's and possibly from Fitch at end-2017. S&P could still downgrade to junk mid-year, particularly depending on the situation

at Eskom, which we expect to show further deterioration in credit metrics when including nuclear and its wider monopolistic mind-set.

We think revising specific forecasts for ratings has little point for the year ahead. Instead, we will have to form an opinion in the month or so before each rating reviews which in 2017 will be spread more widely between the agencies from April to June and then end year in November and maybe start December. The year-end review dates have the extra hurdle of the ANC elective conference being after and the agencies waiting to see the lay of the land for the next political cycle. The fiscal situation, growth and parastatal activity will be key to watch for assessing the agencies through 2017, alongside any progress on what meagre reforms have been announced.

Overall, we think Moody's is most likely to downgrade (but least important given its two notch gap above sub-investment grade), then S&P and then Fitch.

Macro outlook

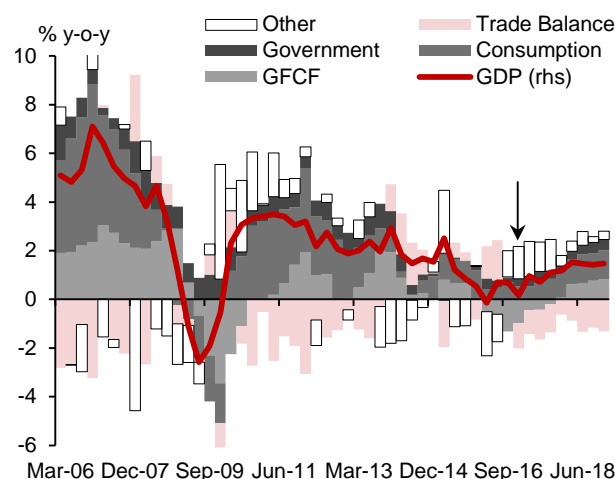
We would characterise the macro outlook for 2017 as another year of minimal job growth and negative per capita income growth driven by low private sector investment, even as headline real GDP growth recovers slightly on base effects after the Nene-gate shock of December 2015 that spilt into Q1 2016. We think inflation will be lower on base effects and lower food prices, but then rebound, meaning long-run inflation is still seen at the top end of target. Overall, this should allow the SARB to remain on hold bar any major weakness in the currency or sudden shift up in its long-run inflation view.

Fig. 7: Forecast outlook

	2015	2016	2017	2018
Real GDP % y-o-y	1.3	0.5	1.0	1.6
Current account % GDP	-4.6	-4.2	-5.1	-5.2
PSCE % y-o-y*	10.2	6.1	6.8	7.1
Fiscal balance % GDP	-3.8	-3.4	-3.1	-3.0
FX reserves, gross USD bn*	41.4	47.5	48.0	48.5
CPI % y-o-y *	5.2	6.5	5.7	5.7
CPI % y-o-y **	4.6	6.3	5.8	5.6
Manufacturing output % y-o-y	0.0	0.2	0.5	2.7
Retail sales output % y-o-y	3.3	1.7	1.6	2.8
SARB policy rate %*	6.25	7.00	7.00	7.00
Gross govt debt %GDP	50.5	51.3	52.8	53.4
USDZAR*	16.47	13.75	15.50	16.50

Source: Nomura Note: * Is end year, ** is year average

Fig. 8: Growth forecast



Source: Nomura, StatsSA Note: Latest data, Q3 2016, indicated

Growth

We forecast growth of 1.0% in 2017 after 0.5% in 2016 and expect 1.6% growth in 2018. How to characterise this is key. In our opinion, the market appears to think of this as a recovery, as does the government. Indeed it is from a low base. However, for us this is still growth vastly below "potential potential" (which is 5% odd with the right policies) and represents yet another year of negative per capita income growth. (We see real GDP per capita growth in 2017 of -0.7% y-o-y after -1.3% in 2016 and then -0.2% in 2018 and -0.1% in 2019.)

We see a very gradual recovery in 2017 across consumption and investment occurring, albeit offset by a slower inventory build and base effects (and actual moves) from a shift in the trade deficit from a real surplus back towards real balance.

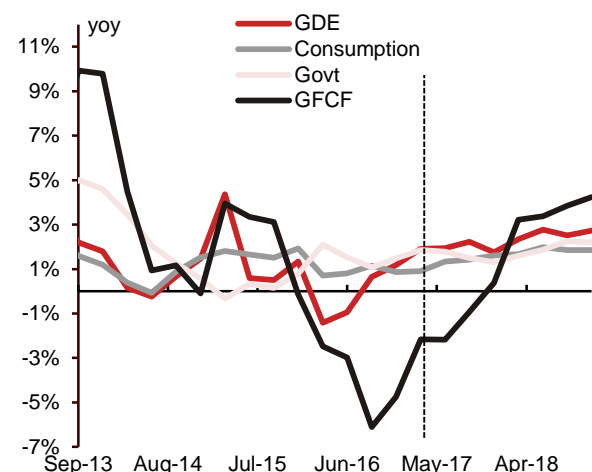
We highlight how muted this recovery is likely to be and that investment growth will not turn positive in our forecast until Q4 2017. The recovery in consumption, e.g., is 0.9% y-o-y in 2016 to 1.3% in 2017. We see lower inflation supporting real incomes and the labour market turning from a net shedder of jobs in 2016 to basically flat in 2017 as also supportive. However, these factors will likely be offset by an NPL cycle from over-indebted consumers and a further slowdown in consumer credit. Risks to consumption may well be slightly to the downside. Risks to investment are two-way. On the upside there could be a faster return of animal spirits and a number of large investment plans especially in the automotive industry. These are balanced with another year of political uncertainty and low FDI.

We think that Nene-gate will still have a long tail through the economy in 2017 and 2018 with little upside risk potential from reforms and a moderately low strike risk year. The national minimum wage, which will come into law in 2017, but will only really bite from 2019 (or 2020 for some sectors), will likely have no discernible impact on growth, be marginally inflationary, but exacerbate inequality between the employed and unemployed households. It will be interesting to see if it spurs mechanisation and investment on that front offset by lower consumption on the other, but such a trend may only be evident in the medium run.

We see the mining sector doing well on higher global raw commodity prices, but shift little extra volume given US protectionism and slower Asia demand. As such, we believe 'Trump' economics should help South Africa on the nominal side, but not on the real side of the balance sheet. Fiscal tightening at the margin should keep government spending ticking over at only a low growth level, but still positive given the lack of any real austerity. Higher taxes in the coming fiscal year should be a marginal dampener on growth, but affecting a narrow consumption base, so we see it as more of a downside risk to growth than an adjustment factor to make now.

We think the growth decomposition of what is occurring is particularly interesting in highlighting the issues facing South Africa – see Figure 10 below.

Fig. 9: Growth component forecast



Source: StatsSA, Nomura

We can see here the key turning point in capital stock growth around the time of Nene-gate as inventory destocking and a collapse in private sector investment have driven this lower. Labour growth has remained low (especially vs pre-crisis), but the most interest is in TFP. Note that the base of TFP's drag on overall growth was in Q2 2016, but it had been steadily declining before that. We think this points to the larger regulatory, political and policy uncertainties in the economy as opposed to simply Nene-gate as an issue that can pass. Hence, we see TFP growth recovering to zero but not contributing in 2017 or 2018.

We think overall growth risks are somewhat balanced in terms of identifiable risks outlined above. The risk is that there are political unknown tail risks that are all very negative up until 2019, at least assuming a status quo outcome from the elective conference. On a surprise outcome, however, we could see some release of animal spirits after a Ramaphosa win, though as outlined above we would be sceptical if any such short-run positive impulse could be sustained through reform into higher potential growth.

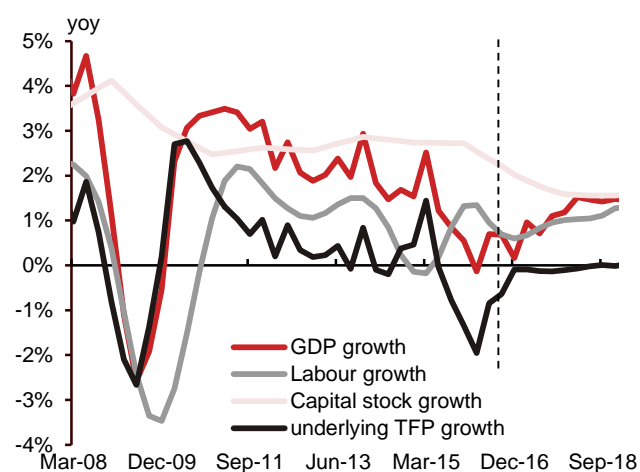
We view underlying potential growth at around 1.3% again in 2017, meaning there is a small output gap, but not significant.

The growth narrative for 2017, thinking high frequency, will be mainly dictated by base effects, a step up for Q1 after a weak Q4 2016 and from the post Nene-gate drop starting in 2016, but then still low q-o-q saar growth each quarter, meaning a slow grind higher in y-o-y prints until year-end.

Inflation

The inflation narrative will be mainly one about non-core inflation in 2017. We think with growth remaining low and ZAR only slowly depreciating through the year, while unit

Fig. 10: Growth accounting decomposition of growth



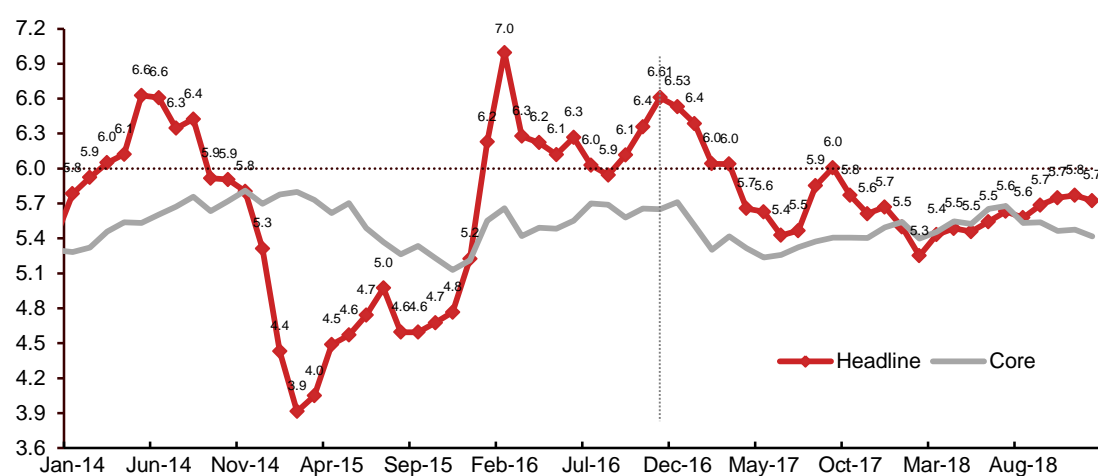
Source: Nomura

labour cost growth remains subdued – core inflation should largely move sideways. We see core inflation coming off slightly in Q1 to low-5% handles before grinding very slightly higher through the coming two years.

For non-core inflation there are two opposing dynamics in H1 – oil prices pushing inflation up and it being pulled down by oil and food price base effects and food raw commodity prices being lower. Food and oil price base effects for H1 are a well-known narrative. But what is less of a consensus view is that the lower raw food prices are seen by us as only passing through partly into negative CPI inflation effects. We think this is because there is an underlying strong asymmetry in the raw food price path through and also because we see a very long tail of impact from the drought into meat and processed food prices even as raw food prices of grains and fruits and vegetables fall away.

The combination of these factors means we see headline CPI inflation as being quite volatile. One reason is that oil price moves feed through very quickly as a result of the administered price nature of petrol. However, on the flip side, we see low growth and monopolistic positions and positive margins still meaning that FX pass-through (to headline and food price inflation) remains at cyclical and record lows in 2017.

Fig. 11: CPI inflation forecast



Source: Nomura, StatsSA

We see CPI inflation in January very elevated because of recent oil price rises only being partly offset by a stronger ZAR. We then see a dip to 5.3% in May before CPI inflation ends the year at 5.6% though, after having first gone through a little cycle to touch 6.0% in September. This is a more bearish view on inflation for the year than the market – especially for the coming base, though that theme has passed somewhat with the market now thinking about oil prices and reflation.

In some ways, this is all academic, as the SARB is likely to be focusing on long-run inflation. We still see average Q4 2018 inflation at 5.7% above the SARB's estimate. This view is very sticky because it encapsulates non-changing views on the structure of the economy, pass through, etc, and we largely see oil prices and ZAR as flat through much of 2018. It does however view unit labour costs as still somewhat subdued and low growth and low pass-through. All these factors have upside risks, which could force this long-end forecast higher.

The shorter-run risks for inflation in 2017 are balanced, in our view. Food price pass-through in a low growth environment could go either way, though risks overall are dampened by lower FX pass-through. The downside skew risk in ZAR clearly adds some upside risk, but we think oil prices may be toward the top end of their range now and US policy could shift it lower. Electricity price risks are to the downside if Eskom is forced by courts to repay past tariff increases, although the timing of this is uncertain and could end up falling to 2018 if it does happen. As such, in our view the broad balance of risks cancels out for 2017.

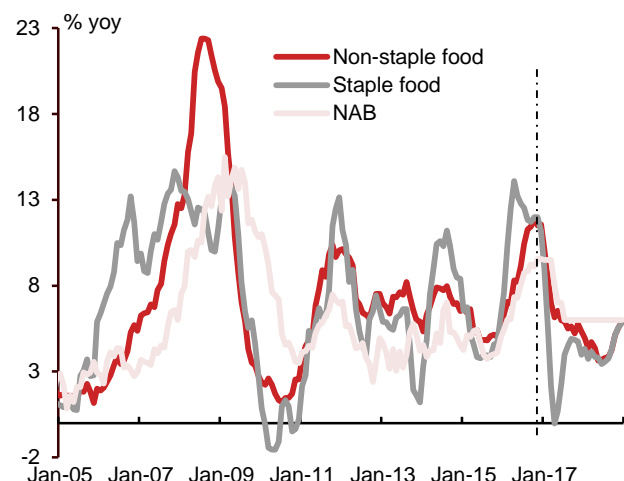
We see average inflation at 5.8% in 2017 after 6.3% in 2016 and then 5.6% in 2018. Overall, we still think CPI inflation is structurally glued to the top end of target and hence what core inflation does is interesting.

We watch meat prices and processed food price inflation especially closely for a view of the base in the CPI being higher and lower, and think core inflation through Q1 and if it

does indeed fall back will be an important milestone for understanding the structure of core inflation and unit labour costs (and expectations).

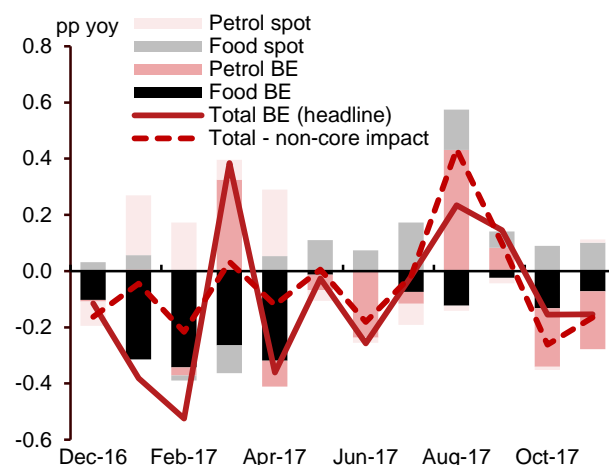
We also need to be cautious on base effects as we think they are being overestimated by the market and this drives some overly large expectations of the drop in CPI inflation to come. Below, we show how food prices drag CPI inflation back, but this is largely offset by moves in spot oil prices and oil base effects. Overall then, the impacts of non-core inflation on headline inflation in the months ahead are actually positive, not negative on CPI inflation. This is because we see low spot prices for raw food not lowering CPI food significantly. We forecast food prices will start rising again through H2 2017.

Fig. 12: Food price inflation and forecast



Source: Nomura, StatsSA

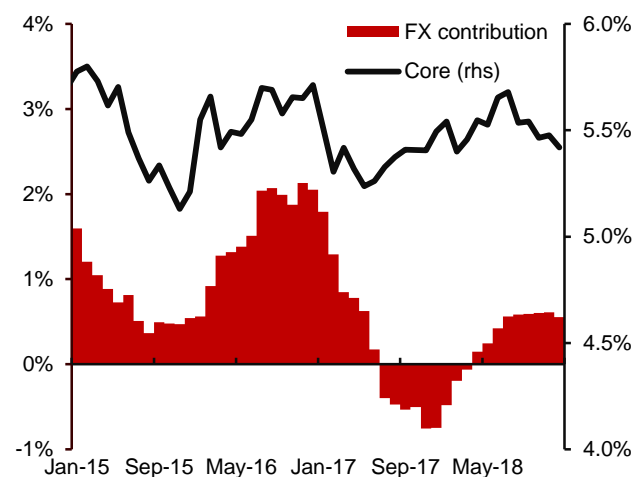
Fig. 13: Contribution of base effect and spot commodity change decomposition on headline CPI



Source: Nomura Note: BE refers to base effects, i.e. past effects on current y-o-y, spot refers to current mom changes cumulative impacts

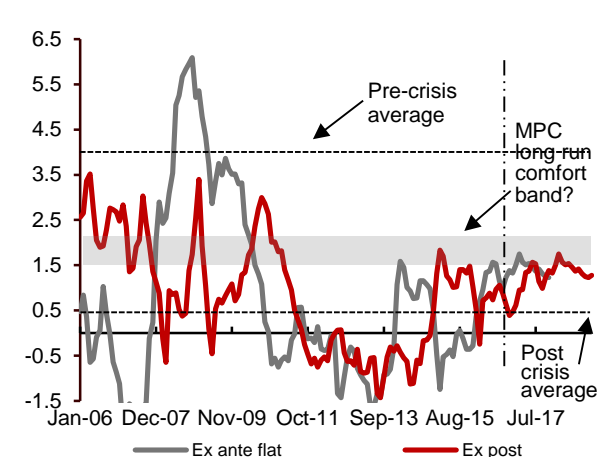
In addition and as seen below ZAR should be a net drag lower on core inflation as the long pass-through lags from 2015 which were a boost give way to recent ZAR strength depressing core inflation. Indeed, this may well be a larger impact on headline inflation than net non-core base effects and spot food and petrol price changes. This assumes the time variable, reduced, level of pass-through continues into the future. We think this provides some buffer for the SARB when viewed through this lens, as we set out in more detail below.

Fig. 14: FX effects in core CPI inflation



Source: Nomura

Fig. 15: Real rates



Source: Nomura Note: To be clear, ex post is current inflation deflating the current base rate, ex ante is the current interest rate deflated by the inflation rate projected in one year's time.

There will be a CPI rebase and reweight occurring with the December 2016 data released this month. We see it having a minimal effect, but as the household survey data that will underlay the weights has not been released, there is a degree of uncertainty. We think overall it might have a slight skew in risks to the downside.

SARB

We stick with our layered forecast for the MPC in 2017 and it encapsulates the SARB's data dependency and uncertainty (especially from the external environment). As such, our strong baseline is that there will be no cuts:

- Expansionary US fiscal policy and US policy rate hikes, together with a strong USD could rattle the SARB from the upside effects on inflation through ZAR emanating from South Africa's dual deficit.
- We think the SARB still sees inflation expectations as only barely anchored.
- It is focused on the long end of the inflation forecast and particularly Q4 2018, which is still above 5.0% and nowhere near the midpoint of its target (4.5%). As such, we think it sees long-run inflation as 'anchored-ish' within target, but not to the degree it would like. We think 2017 will see a greater focus of rhetoric on this mid-point and the unacceptably high nature of the long run forecasts. The SARB will lengthen the forecast horizon out to end 2019 through mid-2017 we think and still see a similar story.
- We believe the MPC has a long-run real rate comfort band around 1.5-2.0% and so with our inflation forecast real rates are coming in a little on the low side (their forecast which is a little lower puts them closer but still just below). We think they are happy sitting at this point in a low growth environment when FX pass-through is seen at historic lows hence no urgency to hike either.
- We think downgrade risk and wider political risk means the SARB remains worried about the signals a cut would send, but also sees little efficacy in cutting in terms of any impact on growth and especially potential growth. The mantra of "it's not our problem to fix with rates" in terms of pressure to cut rates to increase potential growth will again be seen in 2017 especially as growth remains low.
- Broadly we think the SARB is happy sitting just below neutral.
- We would only see the SARB cutting long term if we saw long-term inflation forecasts converge to 4.5% with confidence on anchored inflation expectations, low pass-through and a stable ZAR.

That said, we layer our forecast given the upside risks we see to USDZAR and to inflation, especially core inflation:

- 2016 proved to be an unusually low year in terms of real unit labour cost increases and we think the MPC will see upside risks that could force it to hike if they materialise and then shift the CPI inflation forecast skew to the upside.
- If USDZAR sells off aggressively to over 15.50 (this is our rule of thumb of a level it should be made clear) we would see the forecast skew for it to move decisively and so result in hikes.
- Any evidence of increased pass-through rates from their historical lows would drive a shift in the skew of risks to the SARB's forecast and with it prompt hikes.
- If inflation expectation moves meaningfully upwards there could be hikes too.
- We see hikes as limited to 50bp to remove accommodation and shift us back to neutral rates of 7.50% barring a more dramatic shift in the CPI inflation forecast or skew of risks (such as capital flight – that is not our baseline, but could occur on more global EM disorder emanating from the US).

Overall, we expect another year of the MPC deploying the same "fear cycle" framework that has been in place since 2012 and across the shift in Governor's, concentrating on upside risks, some "discount" given to the low growth environment but minimal and easily removed if fear boil over.

This broad reaction function we think is set in 2017 given a range of institutional factors and personalities and can cope with US-led shocks and domestic shocks. We think the centre of gravity on the MPC remains on the hawkish side of neutral around the Governor. What we could see instead is increasingly detailed attention to rhetoric to keep the market focused on the framework and what it implies. This should drive another year of the SARB viewed as a credible anchor.

Fiscal

A challenge again for 2017 will be that short-run fiscal events (i.e. the Budget expected in the last week of February and the MTBPS in the last week of October) may well look fine in terms of the current fiscal year, but it is all about negative shifts in the long-run forecast and the balance of measures taken in the medium run.

A prime example of this is the lowering of the expenditure ceiling is viewed as a positive but is in fact a mechanical, algorithmic, response to the lowering of GDP growth forecasts continually by National Treasury. The positive is the National Treasury has the political space on the fiscal position to follow through on the algorithmic implications – not that it happens per se. Indeed we see a further reduction of the ceiling on lower nominal GDP growth forecasts.

The key challenge, in our view, is what happens to the primary deficit. We can see in Figure 16 below that the primary balance is expected to shift to a surplus in the current fiscal year and given a desire to stabilise net debt in the medium run with larger funding costs so greater primary surpluses are required. We expect a key message from the Budget in February being a yet shallower pencilled-in projection here and a balanced (or a small deficit) primary budget seen only in the current fiscal year.

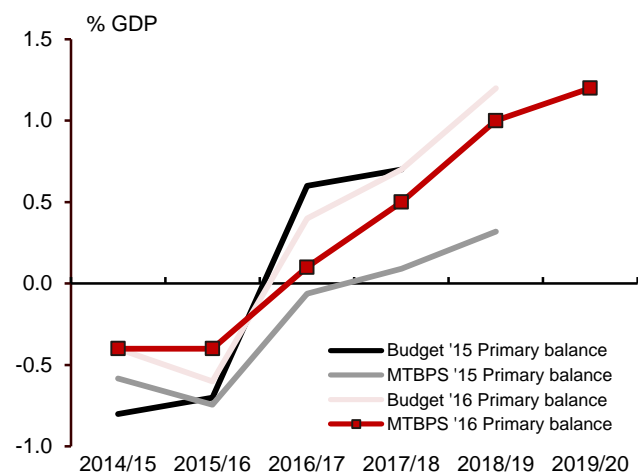
There are also unusually high levels of uncertainty on the Budget (both politically and technocratically) given some ZAR28bn of unspecified tax hikes that are required from the past three budget document updates for implementation in the 2017/18 fiscal year. We think the National Treasury will successfully find these and have the political space to put them in place. While VAT will again be on the table, we see a wider scatter of alternatives, e.g., bracket creep, duties and sin taxes and higher personal income tax hikes as the path used.

VAT hikes are possible, but we think are being saved for any larger requirements on the fiscus for higher education. The situation here means a final outcome from the Fees Commission may not be available for the 2017 Budget, but could fall to increased risks on the October MTBPS. That said, as we saw in 2016 – student protests through the start of the academic year and the State of the Nation Address at the start of February were incorporated in the Budget in February.

On funding we should remember in the new fiscal year from April there will be a 10% odd increase in long ZAR bond issuance levels from the previous (current) fiscal year.

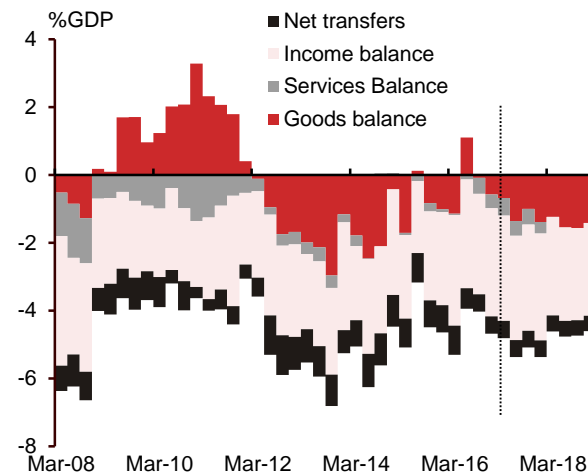
Overall, we expect the budget narrative in 2017 as being focused on trying to get away with as much as possible within the benefit of the doubt ratings envelope and ultimately a judgment on if they are on right side of the line or not. Ultimately, we believe the political environment will require fiscal consolidation to stall at a zero primary balance with the lack of significant per capita income growth also an inhibitor; however, ratings agencies and the market may still focus on the pencilled in consolidation lines and not the actual likely outcomes. As such the fiscal situation should be neutral overall for the market.

Fig. 16: Primary fiscal balance



Source: National Treasury, Nomura

Fig. 17: Current account forecast



Source: SARB, Nomura

Current account

We expect the current account deficit to widen marginally in 2017 from 4.2% of GDP in 2016 to 5.1% of GDP. The main driver of the move will be the trade deficit, which we see

widening because of a stalled recovery in external demand (from Asia especially, partly offset by Europe) and a slight recovery in domestic import demand. This prices in recent terms-of-trade improvements because of higher industrial commodity prices; however, this could be an additional upside risk to the current account (i.e., to a narrower deficit) and is probably the leading factor of uncertainty in this case. We already assume higher oil prices in our forecast which aids part of the widening of the deficit, although this could change with US policy. We assume no Trump boon for exports with only marginally higher US GDP growth in 2017 and protectionist trade measures, meaning volume demand from South Africa (in for instance industrial metals) does not materialise. If anything this could pose a downside risk (to a larger deficit) if US import demand sensitivity falls for bilateral trade.

A major unknown on the import side is what effect Eskom's push back on REIPPP will have on renewables machinery imports. This would bias the outcome to a narrower deficit if it materialises.

We expect the income balance to widen very slightly on larger dividend and coupon outflows being offset to a major degree by higher yields abroad on income. We assume no major shift here, but if US dividend yields and ZAR weakness materialise and are sticky we could see some upside risks here (to a tighter deficit).

Overall, we see the risks to a slightly smaller deficit than forecast.

Parastatal risk

Eskom will remain the one risk to watch with its increasingly monopolistic mind-set, push back on paying renewable feed in tariffs, March deadline for guarantee framework renewal, nuclear procurement process moving forwards and tariff compression concerns depending on court judgements to come. The market has shown particular interest in the nuclear issue, though this will likely be slow moving through 2017. The guarantee renewal process will be a key test of the National Treasury's oversight ability on Eskom following a fractious relationship in 2016 and we will monitor closely what additional conditionality around wider balance sheet risks (such as nuclear and governance) the National Treasury puts on the parastatal as part of this process in the coming months.

The Eskom narrative remains one of reduced domestic demand from a weak economy, allowing profit to be built up from cost reflective export sales. As such, short-run balance-sheet risks remain low, but the equity level and debt dynamics remain stuck at weak multiple levels, albeit stabilised thanks to the last equity injection. Energy security worries ebbed through 2016 as more renewables capacity came on stream and with reduced demand and will likely be further reduced in 2017 with further capacity from coal new built ready to come on-stream into start 2018. As such, the issues on the parastatal are on its build-up of contingent liabilities for the state, its monopolistic mind-set and its effect on the economy, as well as its Public Protector's alleged involvement in tenderpreneurship.

Currency outlook

As usual we will publish separately a more detailed quantitative look on the currency for 2017. However, we have pencilled in a relatively benign depreciation to 15.50 at end-2017 mainly on a stronger USD with outperformance vs peers and most depreciation back loaded into H2 (given the distraction of Turkey). We expect this depreciation to continue in 2018 because of a status quo outcome from the elective conference and further US policy rate hikes that year.

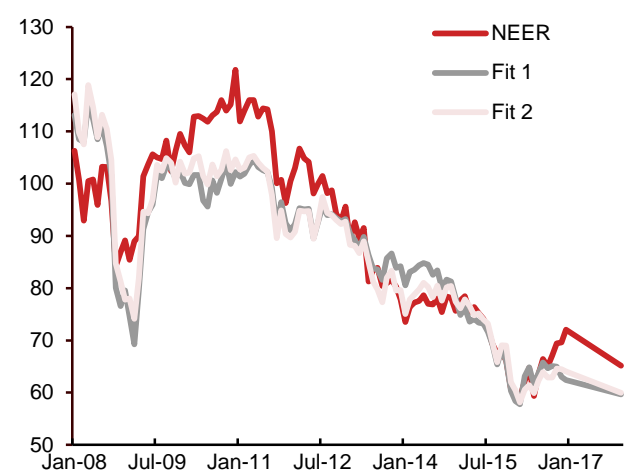
We see moderate downside risks to USDZAR in H1 again on relative value comparisons to peers, but that US policy rate hikes, the US curve and USD strength in H2 mean there is a risk of outflows in H2 from foreigners. Domestic political noise and low growth should add to this, as well as the downgrade risk narrative through mid-year and at year-end. We see foreign investors currently sitting slightly overweight of South Africa bonds and equities at the moment, though still hedged to a moderate degree (well down on H1 2016) and so we think while there may be more marginal scope for position adjustments on bond inflows or outflows we think currency de-hedging in H1 and then re-hedging in H2 will be the larger driver of the currency. The marginally wider current account deficit adds to some negative pressure through the year, with a lack of large FDI inflows this year unlike in 2016.

We see short-run overvaluation in ZAR from our BEER model (it puts fair value around 14.88 based on DXY and CDS among other variables), but this goes to highlight the RV issue driving ZAR stronger here vs Turkey especially and that DXY as a predictor for ZAR (NEER) is therefore of less use here. An alternative valuation model looking at interest rate differentials across the curve puts fair value at end-December around 14.56, again showing overvaluation, but to a slightly lesser degree, picking up on the relative outperformance of South Africa rates. These models suggest ZAR should weaken through this year on a higher DXY and higher US policy rates with the SARB unchanged. The risk is that US policy could disappoint and DXY weaken back or indeed the Fed sees a stronger likelihood of a pause on lower inflationary effects of the form of US fiscal easing chosen.

Figures 18 and 19 below show that our USDZAR end-year forecasts are slightly conservative (actually on the strong side) vs what these models are suggesting for some basic assumptions around year-end levels for US 10yr, USD etc in line with house views.

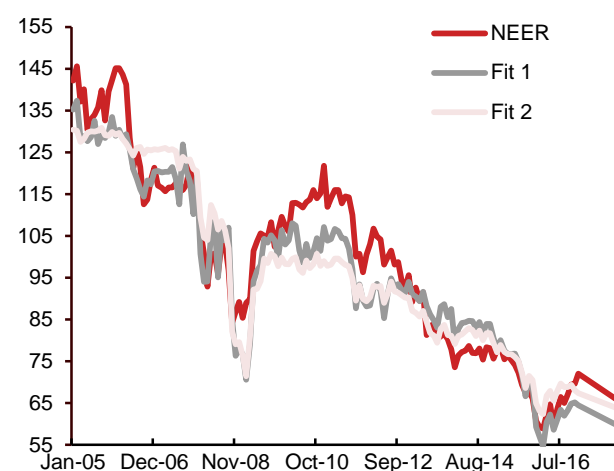
This highlights the justification in thinking about upside skew risk in USDZAR even if we are cautious about pencilling it in.

Fig. 18: ZAR BEER model



Source: Nomura Note: Each fit is a different model specification

Fig. 19: ZAR interest rate differential valuation model



Source: Nomura Note: Each fit is a different model specification

Appendix A-1

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